Switzerland: High Replacement Rates and Generous Subsistence as a Barrier to Work in Old Age

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During the last decade the traditionally high participation rate of elderly workers in Switzerland has remained constant for men and has increased substantially for women. Low social security implicit tax rates epitomize positive work incentives for mid- and high-income individuals, while at the same time generous means-tested social assistance make working longer than the earliest retirement age unattractive for low-income earners. A more subtle reason to retire early is the pure income effect brought about by high retirement benefits for all income groups. These high benefits together with demographic ageing are also the main reason for the unfavourable financial prospects for both the PAYG first pillar and funded occupational pension plans. Interestingly, the financial crisis has not only reduced the value of assets in the funded components of the scheme, but also uncovered structural deficiencies of the second pillar with respect to the funding ratio, regulation and supervision.

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Introduction

The diminishing or stagnant labour market participation of older individuals has a strong impact on the financial sustainability of pension systems, especially now when this is accompanied by falling birthrates and an increasing life expectancy. Several factors, mainly having to do with the incentive structure implied by the pension system, help explain the surge of early retirement in Europe, such as the replacement rate, the pension accrual rate and other related characteristics of the benefit systems. Today, most OECD countries have negative pension accrual rates, which actually discourage older workers to work longer. Another reason for the increase in early retirement is changes in related benefit systems, in particular unemployment and disability benefits: changes in eligibility conditions have basically turned these schemes into early retirement programmes in a number of OECD countries.

Promoting work in old age is thus an important pillar in the reform of social security systems around the world. This also means removing the implicit tax on work implied by low and negative pension accrual rates. In that respect, the higher labour market participation of older workers in Switzerland is an important advantage on the road to pension system fiscal sustainability. As Dorn and Sousa-Poza¹ have explained in a

¹ Dorn and Sousa-Poza (2003).

previous volume of the Geneva papers dealing with the four pillars, the main reason for the high employment rate of older Swiss workers is the low implicit tax rate on working beyond the statutory retirement age in both main pillars of the pension system. In addition to this, Switzerland has a flexible labour market with low unemployment and a shortage of highly skilled workers. Indeed the trend towards early retirement for men in the 1990s was reversed in the last few years. At the same time the participation rate of elderly women has substantially increased. This can be seen as the consequence of a general increase in female labour market participation at all ages, but this is also due to an increase in female retirement age from 62 to 64 years.²

Nonetheless, the financial well-being of the Swiss social security system is far from good. The demographic transition weighs large on the (Pay-As-You-Go) PAYG first pillar, which in the near future is expected to start running a deficit. By 2025 – the year the largest baby-boomer generations only start retiring – the system's reserves will most likely be depleted. But also the fully funded occupational pension system is affected by the shift in demographics. Life expectancy at age 65 has increased by about 3 years since 1985. For a given capital stock at retirement, this increase should have been accompanied by a reduction in the annuitization factor of approximately 15–20 per cent. However, the conversion rate at which retirement capital is translated into a lifelong annuity has remained constant for 20 years.

This article revisits the role of the Swiss social security system for older aged workers and discusses the success of ongoing and planned reforms to restore financial sustainability to the system. The recent developments are discussed in light of more pressing financial concerns due to the demographic transition and turbulences on the capital markets. The article also reviews recent reforms, as well as the obstacles to reforms caused by the direct democracy political process.

Another contribution of the article is to discuss two aspects of the Swiss social security system that have hitherto been largely neglected, but will have to be addressed by future reforms. The first deals with generous means-tested supplementary benefits to recipients of old age or disability pensions. They create strong disincentives to work for low income/low wealth individuals beyond the earliest age at which these benefits can be claimed. The second factor is the *income effect* generated by very high replacement rates even for high-income earners. Many elderly workers may prefer leisure to labour and thus an early retirement, even if work is not implicitly taxed by the pension system.

The second section provides a brief summary of the demographic and economic situation with regard to ageing. The third section revisits the Swiss pension system, focusing on incentives to work at older ages. The fourth section discusses the employment of older workers as one of the solutions to retirement income, adding a potential “fourth pillar” also in Switzerland. A description of recent pension system reforms with an emphasis on the political process follows in the fifth section. The sixth section presents a brief analysis of the financial crisis and its impact on current and future pension benefits and the penultimate section discusses further

² Hanel and Riphahn (2006).

reforms needed to restore financial balance to the Swiss pension system. The last section concludes.

Demographic and economic situation

As in other European countries the demographic situation in Switzerland is characterised by a substantial increase in life expectancy combined with low fertility. Remaining life expectancy at age 65 has increased for men from 15 years in 1985 to 18 years in 2005 and for women from 19 years in 1985 to 21.5 years in 2005. The year 1985 is an important reference point as it corresponds to the year in which the occupational pension scheme became mandatory for all employees with an income exceeding the maximum benefits receivable in the PAYG scheme. The increase in life expectancy of almost 20 per cent was not factored into the determination of benefits and contributions in either of the two pillars of the pension system.

The demographic transition will also result in a substantial increase in the old-age dependency ratio. The ratio of individuals aged 65 and above to individuals between 21 and 64 years will increase from approximately 27 per cent in 2009 to 33 per cent in 2020, 42 per cent in 2030 and 48 per cent in 2040. Although demographic forecasts are notoriously difficult to forecast for a small country with high immigration, the numbers alone show that in the absence of significant changes, the social security system will run into deep financial problems. In fact, substantial migration of highly skilled workers during the economic boom in the last few years helped to alleviate the financial problem of the pension system to some degree.

It is important to mention that, as the population ages, the cost of long-term care expenditures will also increase. Private long-term care insurance is virtually inexistent so that private households pay almost half of the costs. These high out-of-pocket expenditures often lead to a means-tested supplemental pension being claimed. It is thus not surprising that these means-tested benefits crowd out any incentive to purchase private insurance, as has been demonstrated by Brown and Finkelstein³ for the U.S.

As for the economic situation, Switzerland suffered from an extended period of low growth in the 1990s. This triggered not only research whether the country was in a great depression,⁴ but also led to a number of growth enhancing reforms, notably in competition policy. From 2003 onwards, Switzerland experienced relatively high growth rates. At least in part this can be attributed to the bilateral agreements with the EU, which led to free labour movement and a reduction of trade barriers between Switzerland and the EU.

The financial crisis hit the sizable financial sector strongly. The largest Swiss bank, UBS, had to be rescued with a huge bail-out financed by the Swiss government and the Swiss National Bank. On a more positive note, the country was unaffected by the housing bubble and the real sector seems to cope somewhat better than the

³ Brown and Finkelstein (2007).

⁴ Kehoe and Ruhl (2005).

neighbouring countries. Nonetheless, growth forecasts are negative for 2009 (–2 per cent) and zero for 2010.

The Swiss pension system and its incentives for elderly workers

Overview and old age insurance

The core of Switzerland's pension system is more or less equally important in first and second pillars.⁵

The first pillar AHV/AVS is a PAYG system and strives to provide a basic subsistence level of income to all retired residents. Benefits depend on the number of years contributed and to some degree on average earned income. The statutory retirement age is 65 for men and 64 for women. At the earliest, men may claim first pillar benefits at 63 and women at 62 (at actuarially fair reductions in pension benefits). Contributions are proportional to earned income (without a cap) and equal 70 per cent of the revenue, the rest stems from earmarked value added taxes and general government revenues that cover a certain percentage of AHV/AVS expenditures. The liquidity and payment reserves are maintained by a capital account, the so-called AHV/AVS equalization fund. The goal is to keep its level equal to 1 year's expenditures. The ratio of the capital account to yearly expenditures is also used as a short-run indicator to assess the financial sustainability of the scheme.

Occupational pension plans

The second pillar is an employer-based, fully funded occupational pension scheme and is mandatory for all employees whose annual income exceeds a certain threshold. In 2004, 89.4 per cent of working men and 71.1 per cent of working women were involved in an occupational pension plan, which corresponds to 81.2 per cent of the total workforce. An employer can choose between different organisational structures for its occupational pension plan. These range from setting up a completely autonomous pension fund, which covers all risks, to outsourcing the scheme entirely to an insurance company.

The main goal of the occupational pension system is to maintain pre-retirement income in addition to benefits from the first pillar. It insures income above that level that is covered by the first pillar. The threshold explains the lower rate of coverage for women, who often work part-time and thus on average earn less. Most pension funds aim at a total replacement rate of approximately 50–60 per cent of insured income. The net replacement rate after taxes, including income from the first pillar, often amounts to 70–80 per cent for an uninterrupted career also for higher categories of income, and can reach 100 per cent for beneficiaries with dependent children.

The insured income above the lower threshold and below the upper threshold – the upper threshold is equal to three times the yearly maximum single first pillar

⁵ For more details, see Queisser and Vittas (2000); Dorn and Sousa-Poza (2003); Bütler (2004).

pension (i.e. 75,960 SFR or approximately 50,000 Euro) – is called the *mandatory component*, and the income above the upper threshold is called the *super-mandatory component* of the second pillar. Pension insurers are required by law to insure the mandatory share. They are free to provide insurance for the super-mandatory share, but most do for two reasons. First, the second pillar is thought of as an important element in attracting a well-educated workforce to Switzerland's tight labour market. Second, both mandatory and super-mandatory pension components enjoy favourable tax treatment.

The accumulated retirement capital can be withdrawn either as a monthly lifelong annuity (including a 60 per cent survivor benefit if applicable), a lump sum or a mix of the two options. In some plans the cash-out limit is equal to 50 or 25 per cent (the legal minimum) of accumulated capital. Occupational pension annuities are strictly proportional to the accumulated retirement assets (contributions made during the working lifetime plus accrued interest). The capital is translated into a yearly nominal annuity using the so-called *conversion rate*. The conversion rate is independent of marital status, but depends on retirement age. In the super-mandatory part, pension insurers are free to set the conversion factor.

The mandatory part of the second pillar is subject to stringent regulation with respect to minimum contribution rates, minimum interest rates and the conversion rate at which the accumulated pension wealth is translated into an annuity. But then the federal law puts very few restrictions on the contract conditions offered by the insurance companies in the super-mandatory part. Although most pension plans are set up on a defined contribution base, the income guarantees (minimum accrual and interest rates, and the conversion factor) mandated by law for the mandatory part make the defined benefit and contribution schemes in practice very similar. The accrued capital is fully transferable when the individual changes employers. By law, when an employee goes from one company to another he receives all of the accumulated contributions (including the employer's part) that has to be paid into the new fund. Pension funds are requested to index pension benefits to inflation if the financial situation of the fund allows for this. At present, only few funds are able to index pensions to inflation mainly due to the high liabilities created by a very high conversion factor in the mandatory part.

Means-tested supplemental benefits

In case the combined pension income from the two pillars is not sufficient to cover basic needs in old age, means-tested supplemental benefits may be claimed. These additional benefits usually lead to an income that is well above the poverty threshold. Subsistence is thus understood not only as securing a livelihood physically (food, shelter, clothing), but also providing the means to let the individual participate in social and cultural activities. The level of income guaranteed by these supplemental benefits is approximately 3,000 CHF (2,000 Euro) per month for singles and 4,500 CHF (3,000 Euro) per month for a married couple. It is thus far above the minimum income guaranteed in other countries even after accounting for high living costs in Switzerland.

Work incentives: Some neglected aspects

As Dorn and Souza-Poza⁶ analysed before, the first pillar *per se* has little to no direct negative incentives for working in old age due to actuarial adjustments to benefits claimed at most 2 years prior to the normal eligibility age and benefits postponed up to age 70 for most individuals. Less than actuarial reductions may apply temporarily to subgroups, who were affected detrimentally by a change in the law. This is notably the case for women for a given time period after an increase in the statutory age of retirement.

Generous subsistence guarantees

The element, essentially defining the generosity of the Swiss social security system, is indeed the availability of means-tested supplemental benefits for low income/low wealth individuals, which can be claimed in case the combined pension income is not sufficient to cover basic needs in old age. Figure 1 shows that individuals who receive the maximum benefit from the first pillar, but no second pillar income, for example, already qualify for such supplemental benefits. If the combined benefit of the first and second pillars falls below the level guaranteed by the supplemental benefits, any reduction caused by actuarial adjustments in case of early retirement is compensated by the same increase in supplemental benefits. Needless to say, for low-income workers with little non-social security wealth, the incentive to continue working is minimal. Although there exists no direct evidence thus far, BSV/Donini⁷ demonstrate that the share of individuals claiming supplemental benefits is four times higher for early male retirees than for men retiring at age 65.

The availability of means-tested benefits also reduces the need for precautionary savings to cover health care and long-term care costs in old age for all income groups. This in turn reduces the incentive to continue working to cover these costs.

Early retirement schemes in occupational pension plans

For many years, early retirement programmes played a large role in the second pillar for medium to high wage earners and were often subsidised by the employer. For early retirees, many plans also offered a scheme that allowed beneficiaries to receive a bridging pension until the statutory retirement age (and thus the eligibility age for first pillar pension benefits) was reached. In most, though not all cases, the total amount of anticipated benefits drawn had to be repaid to the fund (usually by means of an actuarially fair reduction in the benefit level). Early retirement programmes were also held responsible for the fact that higher income individuals – who are more likely to be covered by autonomous pension providers in lieu of insurance companies – retired earlier than lower income individuals. Bütler *et al.*,⁸ however, show that the negative

⁶ Dorn and Souza-Poza (2003).

⁷ BSV/Donini (2007).

⁸ Bütler *et al.* (2004).

Figure 1. Retirement income as a function of pre-retirement income for a single individual with an uninterrupted career retiring at age 65. NetReplaceRate denotes the ratio of total benefits and labour income net of social security contributions, but before taxes.

Source: Adapted from Bütler and Teppa (2007).

relationship between retirement income and retirement age cannot be attributed to early retirement programmes alone.

While these early retirement programmes have certainly played some role in the decline of labour market participation in the 1990s, they are unlikely to be maintained any longer. The financial pressure of the increase in life expectancy and the less favourable outlook on the capital markets has rendered these schemes unaffordable.

Income effects due to very high replacement rates

Comparable to the contribution made by Autor and Duggan,⁹ who discuss similar effects with regard to disability insurance, retirement programmes can be expected to discourage work not only through the well-known substitution effect; because work often means sacrificing benefits, elderly individuals face a financial incentive to retire. The second, often neglected channel is an income effect: with sufficiently high benefits, many elderly workers may prefer leisure to labour or, more precisely, an early retirement, even if work is not implicitly taxed by the pension system as is the case in Switzerland.

A very high replacement rate is strived for in Switzerland. The goal is set at 60 per cent of pre-retirement income at the statutory retirement age. However, the actual income levels are yet higher when taxes and social security contributions are taken into account. In addition, there exist strong financial incentives for voluntary retirement

⁹ Autor and Duggan (2007).

savings in the form of contributions to both the super-mandatory part of the second pillar, as well as for the third pillar. Although, generally speaking, these contributions are defined as voluntary, households are often implicitly “forced” into saving, otherwise they must forgo significant tax deductions. Furthermore, employers also often feel obliged to offer supplemental retirement solutions, because they otherwise fear competitive disadvantages in the labour market. The consequence is a very high level of old age savings for a broad spectrum of the population, which instead of a greater pension benefit at the statutory age of retirement can obviously also be used for financing early retirement.

Bütler and Zito¹⁰ present preliminary evidence for the importance of an income effect by analysing individual retirement decisions of 6,000 men between 2001 and 2005, taken from administrative records of several Swiss insurance companies that provide occupational pension plans to small and middle-sized firms. While the individuals, who typically are full-time employees, are in the lower to middle income range they would not qualify for means-tested supplemental benefits unless they have contribution gaps.

As in other studies, Bütler and Zito¹¹ find that the higher the accumulated pension wealth, the more likely early retirement is. However, early retirement also increases with pre-retirement labour income. This means that within some income range, higher replacement rates are associated with a later exit out of the labour market. Several explanations can be put forward for these findings: as retirement benefits are strongly related to average lifetime earnings, a higher pre-retirement wage (holding pension wealth constant) means a steeper income profile and thus both better education and potentially more non-pension wealth. For lower income men who do not qualify for means-tested supplemental benefits, the need to generate income seems to be an important explanation in working until the statutory age of retirement. Taken together, the findings lend strong support to the importance of the income effect on the retirement decision.

Removing work disincentives alone might thus not *per se* lead to a later retirement age, at least not for the primary occupation. The findings of Bütler and Zito might also be interpreted in a more optimistic way: individuals with a higher wage/productivity might also have better opportunities to start a second career or be engaged in other activities. Preliminary evidence from the Survey of Health Ageing and Retirement in Europe (SHARE) suggest that this might indeed be the case.

Employment of older workers

As has been outlined above, several important aspects of the Swiss pension system affect the employment rate of older workers, the most important of which being a flexible labour market and low unemployment rates, as well as a low implicit tax rate on working beyond the age of 65 for most individuals. It is interesting to note that retirement at 65/64 years is not mandatory by law, but rather the age of 65 for men or

¹⁰ Bütler and Zito (2009).

¹¹ Ibid.

Figure 2. Labour force participation rates for elderly men and women in Switzerland.
Source: OECD.

64 for women is the condition of eligibility for claiming public pension benefits. However, most labour contracts specify a retirement age – in many cases mandatory – that coincides with the age of eligibility.

The positive work incentives are diluted by income effects due to high replacement rates, even for high-income earners and generous means-tested supplementary benefits. These and widespread early retirement plans provided by occupational pension plans have shrunk the traditionally high labour force participation rate of elderly workers in the 1990s as can be seen in Figure 2. Since the turn of the millennium, the employment rate of older men has been more or less stable and may even be seen to increase slightly again.

An equally interesting fact is that the participation rate of women over 50 years has increased, most dramatically for women between the ages of 60 and 64. The latter might at least be partially due to the increase in the statutory age of retirement from 62 to 64, although the increase was weakened by a transitory decrease in the actuarial adjustment for early retirement from 6.8 per cent to 3.4 per cent. Hanel and Riphahn¹² show that even the relatively small reduction of retirement benefits by 3.4 per cent induced more than 70 per cent of females to postpone their retirement.

The employment of older people may also encounter difficulties due to other factors, such as health and working conditions. Using SHARE data, Bütler and Engler¹³ show that although incentives still dominate all other aspects, health and working conditions play a role in the labour market participation of elderly individuals.

¹² Hanel and Riphahn (2006).

¹³ Bütler and Engler (2008).

Health is obviously a significant factor, which differentiates between those working and those no longer working before the statutory age of retirement. Employed persons in Switzerland are less often afflicted with health problems. However, the factor health becomes less important if the expected instead of actual age of early retirement is considered. From this perspective, working conditions play a prominent role: job satisfaction, appreciation for work performance, but also adequate pay and career opportunities are significant factors in the intention to retire. Those employed, who are satisfied with their working environment, are less likely to have the intention to retire early. This can be interpreted as satisfied employees are better prepared or more willing to deal with any health problems and, due to the positive environment, can. In contrast, however, it is not implausible that dealing with poor working conditions over the years results in mental or physical health problems and finally an early exit from the labour market. It is also possible that a poor working environment *per se* motivates early retirement. Last but not least, it cannot be excluded, that even those in perfect health assert health problems as a reason for early retirement, because this is more socially acceptable (the so-called “justification bias”).

Recent reforms and reform attempts

In contrast to other European countries there was little reform to the pension system in the past 20 years in Switzerland. The main structure of both pillars as well as the contribution levels remained essentially unchanged. A very important change was a silent one: as a consequence of the maturity and enhancement of the second pillar (which was made mandatory in 1985 and replaced the previously voluntary occupational pensions), the relative importance of the funded part of old age security rose and now reaches approximately 50 per cent of retirement income for an average individual.

Blocked reforms in the first pillar

The last fundamental changes to the first pillar AHV/AVS, the so-called 10th revision of the AVS law, dates back to 1997. Its most important elements were the replacement of spousal benefits by individual benefits, an increase in the female age of retirement in two steps from 62 to 64, contribution splitting, child-care credits and a more flexible age of retirement starting at 63 with actuarially fair adjustments. The institutional changes were accompanied by an increase in the VAT earmarked for AHV/AVS by one percentage point. The unpopular increase in the age of retirement for women from 62 to 64 years (gradually phased-in) triggered a number of reactions notably from the left side of the political spectrum. However, many opponents to the increase in age of female retirement chose not to support the referendum opposing the 10th revision because this would have threatened the undisputed parts of the reform package. As a consequence, the 10th revision passed the referendum with a majority of 61 per cent of voters in 1995.

After the referendum, the Swiss Association of Labour Unions, one of the main opponents to the increase in the female retirement age, started a popular initiative

demanding the reversal of this aspect of the reform, as well as the possibility of early retirement. This proposal was rejected by a 59 per cent majority of voters in 1998. In November 2000, two other attempts were made in counteracting the 10th revision of the AHV/AVS with two almost identical popular initiatives. Instead of primarily concentrating on the retirement age for women, both proposals demanded a more flexible and earlier retirement age for both men and women. Despite their similarity, a difference in approval rates of nearly 7 percentage points indicates that the framing of the proposals played an unexpectedly important role.¹⁴

Reforms to the first pillar have been blocked since the refusal vote of the so-called 11th revision to the AHV/AVS in May 2004. This was not only the first reform that was not accepted in a referendum by the electorate, but also the first that primarily focused on (moderate) benefit adjustments and higher contributions in view of the looming financial problems in the first pillar. Exit polls show that the two important reasons for the refusal of this reform were the increase in female retirement age from 64 to 65 and other cuts in benefits with too little compensation for low-income individuals.

At the moment a remake of the 11th revision is being set up with similar goals: this time the increase in the female age of retirement should be mitigated by lesser than required actuarial adjustments for early retirement of mid- and low-income women and men for a period of 10 years.

Uncertain reform prospects in the second pillar

The laws defining the occupational pension have experienced little substantial changes in their structure since its implementation in 1985. The scheme has grown in importance due to its maturity: for mid- and high-income individuals the bulk of retirement income is now generated in the second pillar. Improvements to the portability of accumulated capital removed an important obstacle to occupational mobility. Moreover, during the past 20 years a majority of pension funds changed from what was the dominant defined benefit structure in 1985 to a more flexible notional defined contribution structure. Nonetheless the change for individuals was minimal. Despite economic fluctuations and substantial increases in life expectancy, regulation of nominal interest rates and the conversion factor remained constant for nearly 20 years. The illusion of perpetual stability was only broken by the reduction in the minimum interest rate in 2000 and above all the adjustments to the conversion factor in the super-mandatory part of the scheme in 2003. They were met with uproar and the accusation of insurance companies of “benefit theft”.

The first revision of the occupational pension law was implemented in three steps. In a first step in 2004, new regulations concerning transparency, the dissolution of insurance contracts and the representation of employees and employers in the board of trustees came into force. In a second step in 2005, the remaining changes to its structure were implemented: the entry threshold was reduced accompanied by an adjustment of the coordination offset, both extending the coverage of low income and

¹⁴ See Bütler and Maréchal (2007).

part-time workers. The reform also included an increase in the female age of retirement (mirroring the increase in the first pillar) and a widower's pension. It forced pension funds to allow a cash out of capital at retirement of at least 25 per cent within the mandatory part of the scheme. Twenty years after its mandate, the conversion rate was reduced for the first time but at a very slow pace: the minimum conversion rate, which was equal to 7.2 per cent until 2004 was lowered continuously to 6.8 per cent in 2015. Finally, in a third step in 2006, new tax law regulations concerning occupational pensions were implemented.

The small adjustments to the occupational system's conversion factor implemented in 2005 proved far too small. In 2009, the federal council decided to decrease by a far larger amount in a shorter time. This decision is again challenged by a referendum that attained an unusually high support (200,000 instead of the necessary 50,000 signatures). While many observers expect the referendum to undo the reduction in the conversion factor, some signals suggest that some rethinking is under way. An important consumer advocate magazine does not support the referendum. This would have been unthinkable even a short while ago.

High financial imbalances in disability insurance

The Swiss disability insurance, introduced in 1960, supports individuals who are no longer able to earn their living for health reasons. Although it operates under the principle "integration before benefits", the number of individuals on a disability pension has exploded over the past 20 years. In 2006, 5.2 per cent of the workforce received disability benefits, amounting to 2.9 per cent of GDP in costs. Even more alarming is the high share of disability benefit recipients among the elderly: 10.4 per cent of 55–59 and 12.4 per cent of 60–64. Given that benefits and contributions have remained unchanged for more than 20 years, it comes as no surprise that the scheme now runs a deficit of more than a billion Swiss francs a year and has accumulated debt of 11.4 billion Swiss francs.¹⁵

With the fifth revision of the disability insurance, the principle of integration before benefits was again given the necessary attention. The revision primarily put more emphasis on measures of integration and strengthened the incentives for employers to provide employment to disabled individuals. The great decrease in the number of new pensioners (up to 30 per cent a year) demonstrates that the measures taken are likely to succeed. However, they are not yet sufficient to alleviate social security deficits or even lift social security from debt. This is primarily due to the fact that the 5th revision had little effect on existing pensioners. The reintegration of handicapped people collecting pensions proves to be difficult for a variety of reasons. Employers are generally reluctant to hire physically or mentally handicapped people. But also, the very high replacement rate of benefits, in international comparison, provides a strong incentive to continue collecting benefits.

As in the case of old age benefits, the reasoning behind the financial incentives, which presume a pension, are not only based on disability benefits *per se*, but also on

¹⁵ For more details see Bütler and Gentinetta (2007).

benefits from occupational pension funds, supplementary means-tested benefits and generous supplementary benefits for dependent children from all three sources. In many cases, the loss of benefits associated with a reintegration exceeds possible earnings by far.

Political constraints to reforming the system

The Swiss first pillar AHV/AVS is immensely popular among the public and most political forces. As is the case in other countries, upcoming demographic changes will threaten the financial viability of the system and call for appropriate measures to be taken, such as increases in the statutory ages of retirement. Due to its popularity, the AHV/AVS is viewed as a crucial element in social cohesion in Switzerland. Any attempt to change its structure is closely monitored and triggers widespread discussion in the media.

The outcome of the ballot on the 11th revision of social security illustrates the strong veto power of the population with respect to social security reforms involving benefit cuts. It is also worth mentioning that attempts by left-wing parties to decrease the retirement age and/or increase benefits for early retirees were equally unsuccessful. Contrary to what might be expected neither a booming economy nor an economic downturn seems to play a significant role in voters' responses to AHV/AVS proposals. In 2005 in midst of a boom, a popular initiative demanded an earmarking of the Swiss National Bank's profits for the AHV (with the ultimate goal to finance early retirement). In 2008, only a few weeks after the enormous rescue package for UBS, another popular initiative organised by trade unions proposed to subsidise early retirement for individuals with an average income of 110,000 Swiss francs (a condition met by 85 per cent of men and 95 per cent of women). Despite a total change in economic conditions between the two votes, the two initiatives were rejected with very similar vote shares and support patterns.

The impact of the financial crisis

The financial crisis struck all three pillars of Swiss social security. Due to capital funding and its relative importance in the provision of retirement income, the privately run, but mandatory occupational pension scheme was thought to be the most strongly hit. On average private pension providers suffered from a negative performance of -13 per cent in 2008, with a majority of funds in a range between -7.5 per cent and -20 per cent. Insurance companies that primarily insure small and medium enterprises were affected less due to their much more stringent asset allocation rules.

The negative performance must also be put into context in that an approximate 5 per cent return is needed to secure the liabilities in autonomous pension funds given the current regulatory framework. As a consequence the average funding ratio fell from 110 per cent in 2007 to 96 per cent in 2008. This is all the more troublesome due to the many built-in income guarantees in the second pillar. A funding ratio of at least 115 per cent is deemed necessary by most experts. By the end of 2008, 60 per cent of all

the pension funds under private law had the status of “underfunded”, among the funds under public law the corresponding number was 93 per cent. Measured by the 115 per cent funding goal, virtually all pension funds are underfunded.

As a consequence of the many built-in income guarantees, retirement benefits of retirees and individuals close to retirement age were not directly affected by the crisis. However, most funds will be forced to undergo restructuring involving substantial severance charges. Although these measures will mainly affect working age individuals, benefit cuts for present retirees are no longer off limits (though still difficult to implement by law).

The financial crisis also left deep nicks in the first pillar, AHV/AVS: the AHV/AVS equalization fund lost 18.2 per cent of its value. Depending on the duration of the ongoing economic crisis, contributions will also be affected, reinforcing the negative immediate capital loss of the scheme. The crisis demonstrates that the positive results of the AHV/AVS in the past few years cannot not be taken as a sign of financial health and stability. The increase in reserves due to the economic boom and high income immigration had a side-effect: gloomy forecasts about the fund running out of means in 2025 at the latest were no longer taken seriously by the popular press and many political parties. This opinion has been capsized in recent months.

Further reforms needed

Given the lack of substantial reforms in the past two decades and in view of the looming demographic changes, additional reforms are necessary to restore financial balance to the Swiss pension system. While the basic structure of old age insurance based on the three pillars is generally undisputed, both the first and the second pillar will primarily have to tackle the problem of high benefits compared to contributions. A downward adjustment of benefits either by a direct cut or by increasing the retirement age would presumably also boost work incentives for workers nearing the statutory age of retirement.

A crucial step for both pillars will be an increase in the statutory retirement age as recommended by the OECD (which suggests a gradual increase to age 67). But as the previous discussion has shown, this measure is likely to be controversial in the political debate. As with other major social security system reforms, political acceptance is key for success.

First pillar

The first pillar’s future does not look good. The scheme will start running a sustained deficit in 2012. As a consequence, the AHV/AVS equalization fund will no longer be able to guarantee the liquidity of the system in 2025. If the disability insurance should continue creating deficits and cutting into the equalization fund, the account will be depleted even before 2020. The cure may seem simple – adjust benefits or increase contributions – but the political resistance can be expected to be high. Under these constraints, preference should be given to rule-based adjustments. Previous

experience also suggests that benefit cuts are more likely to be accepted if their impact is mitigated for a certain period (which in turn will lessen the immediate success of the reform).

Considering benefits, indexing retirement age to life expectancy might be an option that is politically feasible. As to contributions, neither employees nor employers are willing to consider an increase in payroll taxes: this would also weaken work incentives and put a disproportionally large share of the burden on the working population. An alternative would be to increase the VAT earmarked for AHV/AVS. In this case the burden would be more evenly spread. Currently another rule-based measure is being discussed in Parliament. The suggestion is to suspend the benefit index to wage growth and inflation, if and when the equalization fund falls below a certain level (the proposal is 45 per cent of expenditures). However, it is unlikely that this proposal will do the job: the necessary reforms would be postponed to a time at which the financial pressure is already great. When this point is reached, the baby-boomers' retirement will deplete the capital account quickly. Even with high wage growth, the adjustments will fall short of restoring financial sustainability by a large margin.

Whatever the solution will be, the necessary adjustments are substantial: in terms of an increase in the VAT, the financial gap amounts to at least 3.5–4 percentage points in the medium run. The importance of reforming AHV/AVS goes beyond the first pillar: it has significant spillovers to the regulation of the second pillar. An increase in the statutory AHV/AVS retirement age, for example, will most likely be adopted also in occupational pension law.

Occupational pension plans

Two fundamental, but related problems must be addressed in the occupational pension scheme. The first one to be realized in the short run is to overcome the underfunding of pension plans partially caused by the current financial crisis. The underfunding, however, is also a structural one. For many years, the imbalance between assets and liabilities has been masked by high capital market returns. Under more realistic return assumptions and taking into account increasing life expectancy, it becomes immediately clear that the promised benefits cannot be financed by employer and employee contributions.

The second long-run challenge will be to change the regulatory framework such that the contributions are adequate to pay for the promised benefits for each generation. As above it would be better and easier to make these adjustments circumventing political process and indexing the most important regulatory variables. These variables include, in particular, the minimum interest rate and the conversion rate that should be tied to observed variables such as average capital market returns and life expectancy. If overly generous benefits were defended much longer, even the healthiest funds would be undermined by unaffordable promises. Had the conversion factor been indexed to life expectancy right from the onset of the mandatory second pillar, the annuities would be 15–20 per cent lower today. This reduction comes close to what is currently at the centre of the political debate and is already implemented in many super-mandatory parts of the scheme.

The current structure of the occupational pension system with extensive income guarantees is tantamount to an insurance between generations. The financial crisis has demonstrated that the systemic risk of such intergenerational risk distribution has been underestimated. Riskless benefits were too high and funding ratios, deemed sufficient to cushion capital market fluctuations, too low in the past. Regulation must take this into account in future adjustments to the benefit component and reserve monitoring. With an appropriate regulation of the minimum accrual rate and the conversion rate, it is still possible to shelter individuals to a large degree from macroeconomic risks.¹⁶

Summary

In her book, Geneviève Reday-Mulvey asserts that “tomorrow’s pension schemes must provide the majority of workers with an incentive to stay in the workforce longer”.¹⁷ In Switzerland, even today’s pension system does a fairly good job of achieving that goal, a better one than many other European countries. After a period of declining labour force participation, employment rates have stabilised at a high level for men aged 55–64 and have increased quite dramatically for elderly women.

This article argues that the low implicit tax rate of the public pension system *per se* is only one component in the decision to retire early. It neglects two channels through which early retirement remains attractive for some income groups. The first channel is provided by generous means-tested supplemental benefits for low income/low wealth individuals. Any increase in income in old age crowds out these benefits one for one. The second channel through which early retirement is attractive is an income effect. The very high net replacement rate from the two pillars and preferential tax treatment of retirement savings seem to induce middle and high income individuals to retire early, even if work is not implicitly taxed by the pension system.

The latter finding also suggests that cutting benefits in the second pillar and increasing the retirement age in both pillars is the route to take to achieve financial sustainability in the Swiss pension system. In contrast to many other industrialised countries, Switzerland has not yet undergone any major reform to its pension system. A number of reasons are discussed in the article. First, high employment rates, a large immigration of highly qualified workers and favourable economic conditions have masked the need to balance the pension system for some time. AHV/AVS finances evolved much more favourably than anticipated and the scheme accumulated substantial additional reserves that made it hard to sell unfavourable measures to the public. Second, any reform to the pension system is subject to a referendum in the direct democracy setting. Previous attempts to implement moderate benefit cuts or increases in the retirement age have been passionately debated and – more often than not – rejected in ballots.

¹⁶ Of course another option would be a complete change of the second pillar’s structure, but such an endeavour is clearly beyond the scope of this article.

¹⁷ Reday-Mulvey (2005, p. 6).

A potentially beneficial side effect of the financial crisis, at least in the medium run, is that the financial imbalances in both pillars were quickly discovered and seem to be acknowledged by a growing share of the population. It can be optimistically expected that the long last launched debate about the future of the Swiss public pension system results in a quick and successful reform to a system that has served as a role model to other countries for a long time; the sooner the better.

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