ESPN Thematic Report:

Assessment of Pension Adequacy in Switzerland

2017

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The ESPN brings together into a single network the work that used to be carried out by the European Network of Independent Experts on Social Inclusion, the Network for the Analytical Support on the Socio-Economic Impact of Social Protection Reforms (ASISP) and the MISSOC (Mutual Information Systems on Social Protection) secretariat.

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Summary / Highlights

- Switzerland has a very high at-risk-of-poverty figure for the 65+ age group (25.2% in 2016). This may be due to high income inequality among older people and to the fact that many pensioners withdraw their mandatory pension as a lump sum. As a result many pensioners are income-poor but asset-rich.
- The severe material deprivation indicator is in contrast very low. At 0.3% for 2016, Switzerland has the lowest rate in Europe, together with Sweden and Luxembourg.
- Groups at risk of inadequate coverage are part-time workers, divorced women and the self-employed. Older pensioners (i.e. 80+) have significantly lower incomes.
- The reform path is uncertain, as a major reform initiative was defeated in a national referendum on 24 September 2017.

1 General description of the national pension system

The Swiss pension system is best described as a three-pillar system. The first pillar (AHV/AVS *Alters- und Hinterlassenenversicherung – Assurance vieillesse et survivants*) is a statutory pension scheme and covers the basic needs of retirees. It is earnings-related with a rather low ceiling and includes a means-tested pension supplement (*Ergänzungsleitungen/Prestations complémentaires*, EL-PC). The second pillar (mandatory occupational pensions) aims to guarantee to retirees a standard of living close to the one they experienced in employment. Finally, personal pensions (third pillar) allow people to tailor pension coverage to their individual needs. They are encouraged by tax concessions. The three-pillar structure of the Swiss pension system is upheld by the Federal Constitution (Art. 111).

The statutory pension (AHV/AVS) provides universal coverage and is a rather redistributive scheme, since there is no contribution ceiling whereas the amount of the benefit can only vary between a floor and a ceiling that is twice as high as the floor. In 2017 the limits were set at CHF 1,175 (EUR 950) and CHF 2,350 (EUR 1,900) per month respectively, corresponding to approximately 20% and 40% of the average wage. Benefits are adjusted every two years according to a so-called “mixed index” derived from the arithmetic average of inflation and wage increases. A full pension is paid at age 64 for women and 65 for men. The coverage of the statutory pension is nearly universal, with around 99% of resident older people receiving it.

The second pillar of the Swiss pension system, mandatory occupational pensions, was introduced in 1985 for all employees with earnings equal to at least twice the minimum AHV/AVS pension (Bonoli 2007; Leimgruber 2008). Occupational pensions are now compulsory for workers earning more than CHF 21,150 per annum (EUR 20,000). This threshold corresponds to about 30% of the average full-time wage. Coverage is nearly universal among full-time employees, but some part-time and temporary workers are excluded. As a result coverage is highly gendered: around 90% for men but only 75% for women, who are more likely to work part time (Bertschy and Müller 2011). Since only employees are mandatorily covered, the rate of coverage for the 15-64 age group is considerably lower, at 73.7% (figure for 2016, OECD, Global pension statistics).

A full occupational pension is granted to employees with a contribution record of 39 years for women and 40 for men. The law provides for a compulsory minimum level of provision (known as the *Obligatorium*) calculated on the basis of notional contributions, leaving existing pension funds a relatively high degree of autonomy over how to deliver and finance that minimum level of provision (but it must be fully funded for private sector employers). Many pension funds (especially in the public sector, or those sponsored by large employers) offer better conditions than the *Obligatorium* (Bonoli and Gay-des-Combes 2003).

The occupational pension law also prescribes a government-set minimum nominal interest rate for second-pillar pension funds covered by the *Obligatorium*. A final important parameter defining second-pillar pension benefits is the annuity rate (*Umwandlungsatz/taux de conversion*) that converts the accumulated capital into an annuity. It is set by legislation, currently at 6.8%. The third pillar consists of voluntary personal pensions. These are encouraged through tax deductions. Employees can deduct payments to a third-pillar pension of up to CHF 6,768 (EUR 5,547) (figure for 2017) per year. The self-employed, who are not covered by compulsory occupational pensions, can deduct 20% of their earnings.

In the mid-2000s, the statutory pension made up about 40% of pensioners’ income, and occupational pensions about 20%. The rest came from work, personal pensions and rents (Wanner and Gabadinho 2008).

Early retirement is possible in each of the three pillars. In the first pillar (statutory pension), early retirement can be taken up to two years before the standard age of retirement, i.e. at age 63 for men and 62 for women. Reductions are actuarially calculated. In occupational pensions, early retirement is regulated by individual pension funds. The law imposes a lower limit at 58. The treatment of early retirement varies across pension funds. Some offer rather generous conditions. Finally, personal pensions can be withdrawn after the age of 60. In general, early retirement is financed by the second-pillar pension.

Deferred pensions are also possible. For the statutory pension, it is possible to delay it until the age of 69 for women and 70 for men. Pensions are then increased by an actuarially determined amount, ranging between 5.2% (one year) to 31.5% (five years). The law allows supplementary occupational and personal pensions to be deferred by the same length of time (five years). The conditions are defined in the individual plans.

Income from work can be combined with a pension. Pensioners with income from work continue to pay contributions to the basic pension, above an earnings disregard of CHF 1,400 (EUR 1,250) per month. These contributions do not generate additional rights.

There is no provision in legislation for arduous or hazardous jobs. However, in some sectors/companies, agreements reached between employers and the unions have led to a lower age of retirement. This is the case in the construction industry, where a branch-based agreement allows retirement at 60. A foundation based on the parity principle collects contributions and pays early-retirement pensions between the ages of 60 and 65. Then the standard pension systems kicks in. This approach is generally considered an appropriate and successful way to deal with the provision of an adapted pathway to retirement for workers in arduous or hazardous jobs. However, it is a rather unique intervention, probably difficult to introduce in sectors that are more exposed to international competition or where unions are weaker (Bonoli 2016).

2 Reform trends

The period 2014-2017 in Switzerland was characterised by intense political debate on pension reform, but no significant legislative change has been adopted. A large pension reform, which would have affected both the first and the second pillar, was rejected in a referendum on 24 September 2017. The reform contained the following main elements:

In the first pillar (statutory pension):

- An increase in the age of retirement for women from 64 to 65.
- An increase in the VAT rate by 0.6 percentage points. The plan was to increase the VAT rate from 8% to 8.3%. In addition, 0.3 percentage points that had been temporarily assigned to invalidity insurance were to be transferred to the statutory pension.
- An increase in all new pensions by CHF 70 per month (EUR 64).

In the second pillar (occupational pensions):

- A reduction in the conversion rate from 6.8 to 6.0%.

Debates prior to the vote on 24 September and a post-vote survey highlighted that the most controversial element was the increase of CHF 70 per month in the statutory pension, mentioned by 39% of 'no' voters as one important reason for their choice. Among left-wing voters and women, the strongest objection was to the increase in the retirement age for women (Swissinfo 2017). In the end, the reform was supported strongly only by the political centre and the centrist left, which proved insufficient. The reform was rejected by 52.7% of voters.

Following the rejection of the reform, the political debate remains intense, as there is widespread agreement that a reform is needed. The failed attempt of September 2017 comes after three previous failures to get a pension reform accepted, by voters in 2004 and 2010 and in parliament in 2010. There is also a relatively general agreement on the need to adopt three of the elements mentioned above: increasing women's retirement age, increasing the VAT rate and reducing the conversion rate in the second pillar.

The main disagreement concerns how to compensate for the reduction in the conversion rate within the second pillar. That this measure is needed is not really contested. The reasons are the increase in life expectancy and the low interest rates environment. However, this measure, if not compensated for, will reduce pensioners' income. The left and the trade unions prefer to compensate for this loss through an increase in the statutory pension, whereas the centre-right is against this option. At the time of writing (November 2017) it is unclear what shape the new reform will take.

3 Assessment of adequacy

3.1 Current adequacy

3.1.1. General assessment of current adequacy

The objective of the Swiss pension system is a combined (AHV/AVS as well as Obligatorium) replacement rate of 60% of gross earnings up to a ceiling equal to three times the maximum AHV/AVS benefit. In Switzerland, the pension system tends to be considered as rather successful in guaranteeing adequate benefits to the retired population. A similar analysis was made by the World Bank in an early assessment of the system (Queisser and Vittas 2000).

This overall positive evaluation contrasts sharply with some of the indicators produced by Eurostat (on the basis of the EU-SILC survey). In fact, Eurostat publishes a very high at-risk-of-poverty (AROP) figure for Switzerland, 25.2% in 2016, which compares very unfavourably with an EU average of 14.5% in the same year. The AROP rate for Switzerland is much higher than that for neighbouring countries such as Austria (13.2%) or Germany (17.6%).

This unexpected result may have two explanations. First, pensioners' incomes in Switzerland are distributed more unequally than in other countries. However, this is due to dispersion at the higher end of the distribution, and low-income pensioners are not exposed to economic hardship to the extent suggested by the very high AROP rate. Second, many new pensioners decide to withdraw their occupational pension as a lump sum (which can by financially more convenient than an annuity). As a result many pensioners are income-poor but asset-rich.

This interpretation is supported by some of the available empirical evidence. First, pensioners' incomes are unequally distributed in Switzerland, more than in similar neighbouring countries. The S80/S20 ratio is 4.6. Only two member states have higher levels of inequality among pensioners (Portugal and Cyprus). Second, the hypothesis that some Swiss pensioners' households are income-poor but asset-rich finds some confirmation in a study based on tax returns. Using fiscal data that include information on both incomes and assets, Wanner and Gabadinho (2008) find an at-risk-of-poverty rate (below 60% of equivalent median income) of around 10% for the 65-69 age group, rising to 17% for the 80+[1]. Single women have higher at-risk-of-poverty rates, though, reaching up to 20%. In general, Swiss studies of income distribution have shown that older people are less exposed to the risk of poverty than other groups, such as single-parent families and large families, although they tend to be more exposed than other working-age people (Wanner and Gabadinho 2008). Means-tested pension supplements are probably a rather effective tool in combating poverty in old age even though there might be a non-negligible non-take-up rate.

The fact that Swiss pensioners are not experiencing economic hardship to the extent that is suggested by the very high AROP rate is confirmed also by the severe material

[1] In the study, 5% of liquid assets (cash) is considered as income.

deprivation indicator. At 0.3% for 2016, Switzerland has the lowest rate in Europe, together with Sweden and Luxembourg.

In conclusion it seems fair to say that older people in Switzerland are faring rather well overall, in spite of the very high AROP rate for this age group. This notwithstanding, it is clear that some sub-groups are more exposed to economic hardship. This is the case particularly for women and older pensioners (above 75). For older pensioners, this outcome may reflect lower lifetime earnings, but also the fact that occupational pensions have only been compulsory since 1985. So, someone aged 80 in 2017 was 48 when the new law entered into force. Assuming that he or she did not have access to second-pillar pension coverage on a voluntary basis, the level of the benefit is bound to be lower than with a full career covered by the new law.

At-risk-of-poverty rates for women are also somewhat higher than the average. This may be explained in two different ways. First, lower lifetime earnings coupled with family risks (divorce) are likely to result in lower benefits. Second, because of longer life expectancy, women are more concentrated in the older age group, who, as mentioned before, enjoyed a shorter period of their working life covered by compulsory occupational pensions.

3.1.2 Redistributive elements of public pension schemes

In the discussion of the redistributive elements of public pension schemes, it is helpful to distinguish between *legally* and *de facto* redistributive elements. By legally redistributive elements, we designate aspects of pension rules (e.g. components of a formula) that intentionally deviate from actuarial fairness in order to provide a transfer of resources between given groups. The notion of de facto redistribution, on the other hand, refers to an uneven distribution within the population of features that determine how much one will pay and how much one will get from a pension system (e.g. life expectancy).

In Switzerland one finds the two types of redistribution, both in the statutory pension and in the occupational schemes.

Within the statutory pension (first pillar) one finds several elements of legal redistribution.

First, contributions are levied on all income from work, without a ceiling. Benefits, on the other hand, have a much more compressed structure with the maximum amount being twice as high as the minimum pension. This means that contributions paid on earnings above an annual salary of CHF 100,764 (EUR 91,000, or approx. 1.35 times median earnings) do not generate any additional rights, and are used to finance benefits for retirees whose earnings are lower than the threshold (Schnegg 2016).

Second, a fairly large proportion of the budget of the basic pension (about 20%) is financed by a contribution by the federal government, which collects most of its revenues from progressive income tax and VAT.

Third, the benefit formula is such that the earning-related pension increases (within the lower and the upper limit) are bigger for low earners.

Fourth, contribution credits are paid to parents of children aged 16 and under. The credit is split between the two parents, regardless of whether either of them reduces working time in order to provide care. The credit has an impact on the pension amount only for those with lifetime earnings below 1.35 median earnings.

Fifth, contributions paid during marriage are shared between the spouses (50% each). In most cases this results in a transfer from husbands to wives.

Schnegg has tried to estimate the extent to which the statutory pension performs vertical redistribution. The task is complicated by the fact that it is unclear what the actuarially fair benchmark could be in a pay-as-you-go system. Assuming a benefit that is strictly proportional to the contributions paid, and assuming that all the revenues coming from general taxation are used to finance pensions of retirees with lifetime earnings below CHF 100,764 (EUR 91,000), she finds that in 2015 some CHF 1.75 billion (EUR 1.52 billion) paid in contributions was used to finance pensions for retirees with lifetime earnings below that threshold. This amount is just below 6% of the revenues collected through wage contributions (Schnegg 2016).

According to this analysis, and possibly contrary to the dominant perception in the country, the extent of redistribution performed by the statutory pension is rather limited. It should be noted however, that the figure of 6% refers only to wage contributions and not to tax revenues, which overall account for 25% of first-pillar total expenditure.

In occupational pensions, actuarial principles play a much bigger role and redistribution is rather limited. Two elements are considered to deviate from actuarial fairness. First, a unisex annuity rate (currently set by law at 6.8% for men aged 65 and for women aged 64). This conversion rate is advantageous for women because of their longer expected benefit duration, which results from both higher life expectancy and a lower retirement age. Second, the conversion rate of 6.8% at age 65 for men is unanimously considered too high, and results in a transfer of resources from current workers to current retirees, whose contributions are insufficient to finance the annuity rate that is applied to calculate their pension (Conseil fédéral 2014).

Finally, both pillars perform some unintentional redistribution, essentially because of life expectancy being related to social class. A study by Wanner and Lerch has shown that education level predicts life expectancy at age 65, with men with higher education living on average 2.7 years longer than those with only compulsory education (the figure for women is 2.0 years) (Wanner and Lerch 2012).

3.2 Retirement conditions for the self-employed and for people in non-standard employment

The self-employed and people in non-standard employment constitute two groups that are at risk of insufficient pension coverage. Their coverage differs in the three main pillars of the pension system.

Statutory pensions (first pillar)

With regard to the statutory pension, the self-employed pay contributions, but at a reduced rate. The combined (employer/employee) contribution rate for dependent employees is 8.4% on all earnings, whereas for the self-employed it is a slightly lower 7.8%, also on all earnings. In addition, the self-employed with low earnings benefit from further contribution reductions. Those with incomes below CHF 17,200 per annum (EUR 16,050) pay a reduced rate. Then the rate increases gradually to reach the standard rate of 7.8% from CHF 56,400 (EUR 52,700) per annum onwards. Benefits are not affected by this sliding scale for contributions, which can be considered as a cross-subsidy from dependent to independent employment. The reform that was rejected on 24 September 2017 included plans to phase out this cross-subsidy.

Workers on non-standard contracts are covered by the first-pillar pension on the same basis as everyone else. To be included in the scheme as a “professionally active person”, one must pay contributions equal to at least CHF 478 per annum (EUR 447). This is a very low amount, which can be reached by most non-standard workers. If this amount is not reached, then the person is still covered by the basic pension, but as a non-active person, and will have to pay a contribution calculated on the basis of his or her assets and non-work income.

Occupational pensions

The self-employed are not automatically covered by a second-pillar pension. They have to voluntarily join such a scheme (where possible). Workers on non-standard contracts are covered by standard provision. They are at risk of insufficient coverage because affiliation to a second-pillar pension is compulsory only for employees earning at least

CHF 21,150 per annum (EUR 20,000). This threshold may not be reached by part-time and temporary workers. An opt-in is not possible. However, some pension funds have a lower access threshold.

Personal pensions (third pillar)

Both employees and the self-employed can contribute to a third-pillar pension, but on different conditions. Employees who are already covered by a second-pillar pension can deduct from their taxable income a set amount of CHF 6,768 (EUR 6,300) and save it in a third-pillar pension. In contrast, the self-employed can deduct 20% of their taxable income, up to a ceiling (CHF 33,840 or EUR 31,600).

There is no distinct provision for workers on non-standard contracts. However, to the extent that these workers tend to be on low earnings, most of their income will be assigned to current consumption, leaving little for voluntary pension provision. It is as a result unlikely that third-pillar pensions will play a substantial role in protecting their income in old age.

3.3 Future adequacy and challenges

In term of adequacy, the main challenges for the Swiss pension system currently concern the self-employed and part-time employees.

The self-employed are at an increased risk of having to rely on means-tested pensions; and also because moving from the status of employee to the one of self-employed allows the withdrawal of the entire capital accumulated in a second-pillar pension. This opportunity is often used to make an initial investment in one's own firm, but may be the cause of poverty in old age. According to a survey, in 2014 some 13% of new recipients of the means-tested pension supplement had previously withdrawn their second-pillar capital in order to set up their own business (Conseil fédéral 2016: 22). The government is currently considering curbing the possibility of early withdrawal of second-pillar pensions in order to set up a new business.

Part-time employment is very widespread in Switzerland, especially among women. In most cases, part-time work is freely chosen and is not necessarily problematic. However, the pension implications of part-time work may be more worrying. For example, it is estimated that the access threshold to compulsory coverage by occupational pensions results in the exclusion of some 220,000 part-time workers, i.e. around 5% of all employees (Conseil federal 2014: 100, figure for 2012).

Moreover, in a simulation exercise, Bonoli et al. (2016) have shown that part-time workers who divorce are exposed to a high risk of inadequate pension provision (i.e. having to rely on means-tested pensions). This risk also concerns workers who have had a relatively strong attachment to the labour force throughout their working life, for example those who have worked at an average rate of 50% or 60% and earned an average wage. With a divorce rate approaching 50%, it is clear that many current part-time workers (mostly women) will end up with inadequate pension provision.

In general, a small minority of workers with medium-to-low attachment to the labour market are at risk of inadequate old age pension provision.

4 Main opportunities for addressing pension-related challenges

The groups identified as most at risk of inadequate pension coverage are also groups that are particularly difficult to cover in the Swiss three-pillar pension system. The self-employed, for example, given the fact that they are not automatically covered by a second-pillar scheme, are by definition more exposed to the risk of inadequate coverage.

The federal government is currently considering plans to limit the extent to which funds accumulated in an occupational pension can be withdrawn before the age of retirement in order to set up one's own business (Conseil fédéral 2016).

With regard to part-time workers, the reform rejected in September 2017 included plans to lower the earnings threshold above which affiliation to an occupational pension becomes compulsory from the current CHF 21,150 to 14,100 (EUR 20,000 to 13,200), which corresponds to the minimum first-pillar pension. This would have led to the inclusion of up to 90% of those who are currently excluded from compulsory occupational coverage (Conseil federal 2014:101). This measure was not among the most contested ones, and could be included in a future reform package.

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