Old-age provision: Sharing the burden fairly between the generations

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Interested readers find an extended policy paper on this topic (in German) with detailed references under https://www.aymobrunetti.ch/policy or https://wwz.unibas.ch/de/finanzmarkttheorie

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« *It is high time to overcome the decades-long reform backlog in old-age provision. What is needed are sustainable, politically feasible solutions.* »

Reform proposals for a pension system that is fair to all generations

- Financial stabilisation of old-age provision through an automatic mechanism that adjusts the statutory retirement age to rising life expectancy (analogous to the submitted pension initiative). Three adjustments possible in combination or individually to increase the chances of success:
  - A default option gives politicians the possibility to decide on stabilisation with alternative reforms. If this does not happen within a certain period, the retirement age automatism comes into effect.
  - A simple working life model allows for a slightly earlier retirement in the case of physically difficult occupations.
  - Should the 11th AHV reform fail, the automatism can also be introduced while maintaining a lower retirement age for women with parallel increases for both sexes.
- Reform of the 2nd pillar by introducing automatic mechanisms for the adjustment of the minimum conversion rate and the minimum interest rate and a minimal flexibilisation of pension entitlements through selectable different investment strategies.
- Financial incentives for work after retirement age through tax relief and/or exemption from AHV contributions that no longer form pensions, in order to counter (unfounded) fears that older employees will be disadvantaged. Implementation as soon as possible, i.e. before the main reform is implemented.

Rising life expectancy and a decades-long reform backlog have put the Swiss pension system in huge financial difficulties. So far, it has only been possible to avert a financial collapse by redistributing billions from young to old. This contradicts the constitutional mandate of a sustainably financed old-age provision and increasingly endangers the intergenerational contract. It is one of the greatest political failures in our country that no sustainable solution to this problem has yet been implemented. This is all the more serious because - unlike with similarly fundamental challenges such as in European or climate policy - we can solve the problem on our own with goal-oriented domestic policy reforms.

Against this background, the recently submitted pension initiative, which provides for a gradual adjustment of the retirement age to life expectancy, is a unique opportunity. In our view, it is the central reform to realise a pension system that is fair to all generations. However, due to foreseeable resistance that endangers a timely implementation, we propose adjustments here that retain the core idea but, in our view, increase the political chances of realisation. These considerations could be incorporated into a possible counter-proposal by the Parliament. In the 2nd pillar, we also recommend the introduction of certain automatisms and a minimal flexibilisation of pensions. Rapidly realisable tax relief for old-age work should facilitate the main reforms politically and therefore complete a reform package that is, in our view, purposeful.

Massive redistribution from young to old

Many people are not aware that the two main pillars of the Swiss pension system are already far from being sustainably financed. Since 2014, the 1st pillar (AHV) has had more expenditure than income practically every year, and for a long time now, substantial funds have been flowing from the employed to the pensioners every year in the 2nd pillar (BVG) in order to finance the promised pensions.

Even more worrying is the view into the future: without adjustments, these financial imbalances will be massively extended; the AHV fund, for example, will be empty in the 2030s. The fact that the systems can be maintained at all today is due to the fact that Swiss old-age provision has mutated into a continuously accentuating redistribution system from young to old. And this without this redistribution having been planned or intended or ever having been consciously approved democratically. With every year that nothing is done, this redistribution intensifies.

The natural solution is that the retirement age must rise proportionally with the increase in life expectancy.

Correcting this preferential treatment of the elderly should actually be the undisputed central priority of any fundamental reform of old-age provision. On the one hand, for reasons of fairness, but on the other hand also because an accentuation of this redistribution could seriously threaten the intergenerational contract.

The central cause of this threatening financial development is that in the current system something decisive is dynamic, namely life expectancy, and something else, equally decisive, namely the retirement age, remains rigid. As a result, the financial situation must deteriorate with every additional month of average life expectancy gained, because more is paid out but no more is paid in. This dynamic is constantly being exacerbated by the fact that baby boomers will still be retiring in the next ten years or so.

Exactly three political levers

How can this imbalance be fundamentally corrected? On the one hand, the financing situation of old-age provision is determined by factors that can hardly be influenced by policy-makers in a targeted manner, especially the birth rate, immigration and economic growth. As helpful as an improvement in these factors would be from the perspective of the financing situation of old-age provision, they cannot be directly changed by politics with concrete measures. On the other hand, there are three factors that are directly driven by political decisions: the retirement age, the level of pension entitlements and the financing from taxes. The retirement age influences both the revenues and the expenditures of old-age provision, while the pension entitlements only affect the expenditures and the levies (taxes) only the revenues.

Relying on the principle of hope that exogenous factors will improve - for example, that future productivity growth will be higher - is not responsible action against the growing financial imbalance of old-age provision. Effective pension reforms must rather actively change the three politically controllable factors. The natural solution to the problem would be to make the rigid element in the system more dynamic. And that means that the retirement age must rise proportionally with the increase in life expectancy.

Main reform: extend working life

The central element of our reform proposal starts with the popular initiative "For a secure and sustainable pension system (pension initiative)", which was submitted in July 2021 with about 145000 signatures. The initiative provides for a gradual increase of the retirement age for both sexes to 66 years and then to link it to life expectancy. Implementing this proposal would substantially reduce the sustainability problems of the Swiss pension system in one fell swoop.

In view of the political discussion to date, however, it could well be that major political obstacles stand in the way of a prompt implementation of this project. Since the pace of such a reform is essential, we propose to slightly supplement the model of the initiative in order to counter possible reservations. Three adjustments implement the basic concern, but individually or in combination could help to mitigate certain political resistance and speed up realisation:

Firstly, the inclusion of a default approach: politicians are explicitly given the option of reducing or avoiding increases in the pension age if they implement an alternative reform within a given period (via contribution increases or pension cuts) that improves the financial situation of the pension system. If this does not succeed, the retirement age will rise. The idea of this approach is to get away from the "full automatism" of the initiative, but at the same time to guarantee that reforms cannot be postponed at will - as has been the case in recent decades. Politicians are given a certain amount of room for manoeuvre during a given, relatively short period of time by being able to prevent an increase in the retirement age that is pending according to the initiative by making corresponding adjustments to the other adjusting screws (contribution increases and pension reductions). In parallel, such alternative reforms are always subject to the premise that if they fail, nothing will be done, but the retirement age will automatically rise according to the agreed formula. The financing of old-age provision thus adjusts to rising life expectancy in any case, but the default approach gives some flexibility in which way this is done.

Secondly, the inclusion of a simple working life element: For example, anyone who has worked full time for 44 years after completing their education and is at least 64 years old can retire without any penalty; this number of working years will also be adjusted to life expectancy with the same frequency and to the same extent as the normal retirement age. The idea of this supplement is to give more consideration to individual professional careers with an administratively manageable effort than would be the case with a rigid retirement age that applies to everyone. This is intended to take the edge off a politically powerful counter-argument to raising the retirement age. Using the example of construction workers, it is often argued that in certain professions an increase in the retirement age is physically unreasonable. Since this argument is relevant in jobs where people enter the workforce early, a working life model can help here. Those who have paid into the pension scheme for a certain, fixed number of years without interruption with an 80 to 100 per cent workload can - if he or she so wishes - retire a little before the normal retirement age. For everyone else, i.e. the vast majority of the population, the regular retirement age would remain binding. This is administratively much simpler than a fully developed working life model, since one does not have to calculate the individual retirement age for each person. Instead, there is an option (but not an obligation) to retire early without any losses by proving a certain number of years of work.

Fierce political resistance could also arise because of the alignment of the retirement age of women with that of men. Thirdly, if the reform is in danger of being significantly delayed because of this, it could be considered to forego this equalisation and to increase the retirement age for both sexes in equal steps, starting from the existing level. Such an approach would hardly be materially justified against the background of the higher life expectancy of women, but could at least be considered at the beginning in the interest of a faster realisability. This addition would be worth considering above all if the equalisation of the retirement age in the 11th AHV reform should fail. Implementing the initiative with or without the outlined adjustments would not only have an effect on the 1st pillar, but would also substantially ease the financing situation in the 2nd pillar. In the 3rd pillar, there would be more time to accumulate private savings. This model should also provide for the possibility of retiring a few years earlier or later, provided that the pensions are actuarially correctly adjusted in this individual flexibilisation.

Additional reform for the 2nd pillar

Massive, unintentional redistributions occur in the 2nd pillar because necessary adjustments are made only hesitantly and much too late due to the political determination of the central technical parameters. This reform therefore aims to automatically adjust the two central parameters, the minimum conversion rate (MCR) and the minimum interest rate, to changes in life expectancy and the capital market situation. At the same time, a certain degree of flexibility in pension entitlements is intended to create minimal choices for insured persons in terms of investment strategy.

The focus of the reform is on making the conversion rate (CR) more flexible. For the compulsory part of the 2nd pillar, this is fixed by law today and is mainly responsible for the massive redistribution of wealth from young to old. This redistribution is fundamentally contradictory to a funded pension system and could be avoided by a correct calculation of the CR. This depends on two factors: life expectancy and the technical interest rate, which is used to discount the promised future benefits. There are proven assessment bases for both determinants, which do not require discretionary decisions once the degree of certainty about the amount of pensions to be paid out has been determined.

Furthermore, current practice gives pension funds too much leeway to adjust the assumed life expectancy and the technical interest rate to current circumstances, which is responsible for additional redistribution effects. With regard to life expectancy, the generation tables provide actuarially supported projections of future life expectancy. The financially adequate level of the technical interest rate, in turn, reflects the expected return on retirement assets.

If, as in the current system, a fixed old-age pension is promised, the technical interest rate would have to correspond to the interest on risk-free investments with a term that equals the projected pension duration. However, this approach is unrealistic: as the last decade has shown, even long-term, risk-free interest rates are subject to considerable fluctuations over time and can also fall to a level that does not allow sufficiently high, secure pension promises.

The current practice of not using the current risk-free interest rate as the upper limit of the technical interest rate, but rather an expected return on typical pension fund assets determined according to comprehensible criteria, can be retained in principle. However, the prerequisite is that both the pension promises and the current pensions are evenly adjusted to the updated value.

The problem today is that the technical interest rate, which shows an expected return, is considered or used as a return guarantee. Expected returns reflect risk premiums (apart from the risk-free interest rate) and can only be earned through investment risks. These can be smoothed over certain years, but not avoided. Therefore, annuities need to be made more flexible to changing return expectations. A final determinant of the CR is the time of retirement. In order to take the main reform into account, the CR must be adjusted to the retirement age.

The minimum interest rate can also be automated and thus depoliticised. For the active insured, this represents an interest rate that is fixed annually in advance and thus risk-free, and must in principle be aligned with the risk-free interest rate applicable on the capital market. In order for there to be scope to achieve a higher average return through risky investments, the minimum interest rate must be set below the risk-free interest rate in the long term and to an extent that is to be defined. At the same time, the insured persons must be guaranteed a right to participate in a good investment performance as soon as the pension fund has free funds available. In contrast to current practice, the returns achieved must be passed on to all insured persons to a defined extent and equally.

If investment risks are unavoidable, insured persons must have a minimum of choice regarding the investment risk of their assets, at least during the active contribution period - in the BVG as well as in the non-compulsory part of the 2nd pillar. Therefore, the pension funds should offer a minimum number of investment vehicles to choose from, which differ in terms of the risk profile of the investments, as has already proven to be the case with the 1e plans.

Lack of jobs?

Ultimately, there is no way around raising the retirement age in Switzerland, and it is crucial to implement this step as quickly as possible. However, there is the potentially decisive counter-argument in the political discussion that there would be a lack of jobs to employ people over 65. As plausible as this may sound, it must be clearly stated: This fear is completely unfounded.

Ultimately, the fear is based on the economic misconception that the amount of work is somehow predetermined and that therefore the over-65s cannot find jobs or take them away from younger people. Experience so far shows why this reasoning is completely unfounded. The fact that the amount of work is not fixed can be seen from the fact that since the early 1990s the number of people in work in Switzerland has risen from just under four million to more than five million. This reflects the fact that a very large number of additional workers have entered the Swiss labour market in recent decades, in particular because of the rising female employment rate and substantial net immigration.

If there really were a fixed amount of work to be distributed among those willing to work, then both developments should have led to a sharp decline in employment among Swiss men. There is no question of this. The additional workers were integrated into the Swiss labour market simply by increasing the number of jobs. Why should it be any different if, with an increase in the retirement age, additional over-65s will remain in the Swiss labour market?

But what is wrong with the equally often heard argument that older unemployed people hardly have a chance on the labour market anyway? This is already wrong today and will become increasingly invalid in the future in view of demographic developments. If we look at the statistics, we see that the employment rate of over-55s in Switzerland has risen significantly in recent years and is now one of the highest in the world. Their unemployment rate is significantly lower than the Swiss average - this is also true when looking at the labour force participation rate, which includes long-term unemployed people who have left the labour market. In general, it can be said today that older people are unemployed for somewhat longer, but that in percentage terms the same number of over-55-year-olds as younger unemployed people eventually find a job again. In view of these facts, there can be no question that older workers have few opportunities on the labour market.

Moreover, one thing is certain: the chances of the unemployed of all ages will soon improve markedly. In the near future, the baby boomers, who have a particularly large population, will retire and the coming cohorts will be much smaller. Companies will therefore be increasingly confronted with labour shortages. In addition, there is another advantage of raising the retirement age for employed persons: problems of individual older unemployed persons re-entering the labour market often have to do with the fact that they are perceived as being relatively close to retirement and thus certain companies shy away from the investment of hiring and training them. If, however, the rigid limit of 65 falls with an increase and flexibilisation of the retirement age and it thus becomes normal to still be employed after that age, then this argument is clearly invalidated.

If the labour market functions properly - as is undoubtedly the case in Switzerland with its record-high labour force participation rates - the employment of even a large number of over-65s will not be a problem.

Complementary reform because of old-age work

Despite these convincing arguments, the fear that older workers will be disadvantaged in the labour market is likely to be the main political obstacle to extending the working life. In order to counter this somewhat further, we postulate here complementary reform approaches that can be implemented relatively quickly. The basic idea here is to set incentives to alleviate any reservations against employing people over 65. Of the various conceivable reforms, we would like to highlight the two approaches that we believe have the best chance of realisation:

Tax reduction for persons who work beyond retirement age: Because the AHV contribution obligation applies to income above a relatively low exemption amount even after retirement, additional income for old-age provision is generated today without additional expenditure. The effect of such a tax reduction on work incentives could be relatively high because pension and work income are added together for tax liability, which often leads to high marginal tax rates in view of progressive income taxes. A tax reduction increases the incentives for older workers to work longer and at the same time makes them more attractive to employers because their wage claims should tend to be lower due to the tax reductions.

Significant reduction of the AHV contribution requirement at retirement age: Since payments into the AHV beyond retirement age do not build up pensions, they are purely a tax. A reduction of this contribution obligation, which is ultimately difficult to justify, significantly above the current exemption amount would have the same positive effects as the tax reduction discussed above. In contrast, however, it would hardly bring about a direct improvement in the financial situation of old-age provision.

To the point

We should part with the current, completely unsustainable policy with a fundamental reform in order to be able to pass on a functioning three-pillar system to future generations. The approaches outlined here could realise this vision and thus prevent the political stalemate from continuing to cement the status quo to the detriment of younger generations.