LI-Paper

The Swiss Three-Pillar Principle: Dismantle, Extend, Reform?

ROBERT NEF* • October 2002

I am not very optimistic on the success of the reform of pension systems in democratic welfare states. All over the world we can observe different experiments with coercive state based pension systems, voluntary capital based systems, (collective and individual) and family based systems. Most countries try to combine somehow the different types of social security, but the systems are rarely sustainable. The so called "Swiss Three Pillar Principle" can be seen as an illustrative case and as a framework for the debate on reforms, but not as a shining example.

In a multitude of ways, Switzerland is a special case and cannot be regarded as a model. However, despite its defects and the fact it has not passed the sustainability test, our highly complex system of collective and private pension provision does contain elements of an experiment that has been successful in part. In some cases, individual components of the system are interchangeable and this is evidence of a certain robustness and an ability to undergo gradual reform. However, for how long, in what combination and with what funding mechanisms the three pillars will survive remains to be seen. The problem of sustainability has not been resolved for the longer term (10 - 20 years) and the taboo on certain alternatives could hit the weakest members of society hardest.

Since its creation in 1291, Switzerland has regarded itself as neither a state nor a nation but as a "co-operative", a co-operative bound by a common oath. Our community is founded on mutual self-help motivated by economic and military reasons and based on a model under which all co-operative members enjoy the profits and suffer the losses. The essence of a co-operative is an association of individuals who come together for economic reasons. In the Middle Ages, it was felt that the economy – on its own – could not be trusted fully to guarantee permanent and profitable co-existence. As a result, the economic principle of mutual self-help was combined with the metaphysics of a common oath and members swore to stay together irrespective of the emergency or the danger.

Every pension system is a type of co-operative bound by a common oath and is based on mutual benefit – the co-operative element – which is coupled with a mutual belief – a type of oath of adherence to a common myth – which allows joint speculation on future developments in state, economy and society.

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In political and economic terms, the Swiss Three-Pillar Principle of collective pension provision was not created until after the World War II. However, it has its roots in Swiss history dating back more than 700 years.

Mythical and monetary roots of the pension system

The alliance between the three founding members can be interpreted as a conspiracy against the aristocracy of officialdom, as a revolt against the overseers, who demanded compulsory labour and taxes, restricted freedoms and in return offered collective security. The aristocracy of officialdom was destroyed in a series of individual actions, castles were razed and attempts to restore seigneurial structures and establish centralist structures rendered impossible in a series of successful defensive campaigns. One such success was the action by self-armed militia to provide common co-operative security. Not long afterwards, this developed into a system whereby the efficient defenders were exported to act as mercenaries for numerous military commanders in Europe. Admittedly, this export business did run into problems and after some 200 years became a victim of its own success. Swiss mercenaries occasionally came face to face with compatriots fighting in another hostile army and the influential and competing middlemen, who acted as agents, were divided about who at any given time was the wealthiest, most reliable and politically most acceptable customer. This is an early and impressive example of Schumpeter's hypothesis of the "Self-destruction of capitalism". Battles where Swiss mercenaries faced their own compatriots and killed one another may well have reduced the burden on war coffers – after all you do not have to pay a dead mercenary. However, for those directly affected and involved it placed an unacceptable strain on the credibility of the co operative ideal and the oath of unity. As a result, it was inevitable – even before the wars of religion – that this solidarity would collapse. Only the concept of neutrality could ensure that the system of alliances continued, i.e. the limited supply of solidarity inside the country was carefully managed by dispensing with solidarity vis-à-vis those outside.

In 20th century Switzerland, we do not distribute trust and mistrust in the same way as our oath-swearing forefathers. Today, we rely primarily on the economic basis of co-existence; i.e. it must be worthwhile to be a citizen of a country. Nowadays, hardly anyone is prepared to rely unreservedly on an oath to act as a bond for patriotic existence. Those who – without any patriotic illusions – ask what the Swiss share may well first think of its currency, i.e. the Swiss franc, then its militia army (albeit this is of declining importance), national taxes (of increasing importance), the principle of semi-direct democracy and – of course – the high standard of living. However, the most reliable bond which now keeps the Swiss together is the retirement and survivors' benefit insurance, i.e. the AHV. To a certain extent, we swear an oath to pensions: we are pension confederates. Switzerland is not alone in this respect.

Nowadays, nation states survive not by the patriotism that they can mobilise but by the collective egoism of their social insurance systems.

This may annoy not only patriots with a metaphysical belief in the fatherland but also dyed-in-the wool critics of the welfare state. The argument that it is precisely the bond of the welfare state that now creates our national identity does not make its privatisation any easier. We are based – whether we like it or not – on a new materialistic synthesis of nationalism and socialism, which in turn is dependent – at the international level – on a system of functioning capitalism. Pension systems only survive if they have an economic basis – achieved either through taxes or profitable investment – and this economic basis in turn presupposes economic growth. This applies both to pay-as-you-go systems (First Pillar) and capital-based systems (Second and Third Pillars).

The unofficial "founding father" of Swiss social insurance, the legendary Arnold Winkelried, is said to have flung himself heroically onto the serried spears of the Hapsburg cavalry during the Battle of Sempach in 1486 so that his body might act as a breach in their seemingly invincible ranks. According to legend, his final words were said to have been: "Look after my wife and children, I will clear a path for you". This sacrifice by an individual in the service of his community is regarded as the birth of the state retirement and survivors' benefit insurance in Switzerland, even though the latter was not established until 1948 after an intervening period of some 500 years.

Admittedly, the unofficial version of Winkelried's last words are somewhat less heroic: "Wele Säuchaib het mi gschupft", which translated freely means: "What idiot pushed me?"

This shows that any pension system can be based on contrasting versions of the same myth surrounding its creation. The idealistic version and the more realistic version of the myth cover the whole gamut of conflict embodied in collective pension provision. We could analyse our entire social existence – in terms of science, political economy and social psychology – by reference to the principles in "Winkelried I" and "Winkelried II": to make a sacrifice and to be sacrificed. Myths, like reality, are often ambiguous. However, that is why they are attractive – they can co-exist even if full of contradictions. Woe betide those with no myths; but equally woe betide those whose existence relies solely on myths, e.g. on the myth of a long-term functioning pension system based on the pay-as-you-go system.

Robust coalitions despite a dwindling financial basis

Our common belief and our common hope are based on the continued existence of the collective pension provision. This is the holy cow, which must not be slaughtered as long as it provides milk on which the majority are or will be dependent. But what if the milk is thinner and the yield declining?

Nation states are a politico-economic community of those in debt to subsequent generations, who try hard to ensure that the inter-generational pension compact remains unbroken.

The prognosis is poor for the First Pillar of our pension system, i.e. the retirement and survivors' benefit insurance (AHV), which is based on the pay-as-you-go system This, at the very least, should make us stop to think if we reflect that the AHV is one of the supporting pillars of the national consensus or if you prefer, "the mutual oath" now made by confederates. What happens if one of the supporting pillars fails? Does this again herald a time when empty coffers will necessitate a call for new oaths that we would all have to swear? However, if the coffers are empty, is there any reason to form a new alliance, as a community laden with obligations and debts in search of new believers or creditors in the next generation? Romantics see the nation state as the link between past and future generations. There is no denying the fact that apart from the wealth in gold held by the state – now of declining economic importance – there is a socio-cultural and traditional fund of myths and realities, which can be classed as an asset, as a national social capital, in respect of which it is impossible to say with any accuracy whether it is only "pay-as-you-go" or whether it is capital based.

The risk of a collapse of the AHV, based as it is on the financial pay-as-you-go principle, should not be understated. The fact is that a dwindling number of people in gainful employment must fund a dramatically increased number of pensioners. We need no complicated model to establish that a system, which is based on an average life expectancy that in Bismarck's time was actually slightly less than the retirement age of 65 years, cannot function in the long term if we consider current life expectancy and a social climate in which demand is increasing faster than the available supply. There is certainly no shortage of rescue plans consisting of a combination of reduced benefits (initially from the "well-off" who – as the "principle of no need" is wont to say – can do without), higher contributions, additional subsidies from tax revenues (primarily through an increase in VAT) or new consumer taxes. However, nobody in Switzerland is seriously talking about abolishing the First Pillar and relying solely on the Second and Third Pillars, i.e. an end to the pay-as-you-go system and a privatisation of the entire system of pension provision similar to the Chilean model (see the Chilean Model developed by José Pinera).

The welfare-state-minded and nationalistic coalition of pensioners and soon-to-be-pensioners occupies a tremendously powerful position in a mass democracy.

Demographic change is not only increasing the proportion of non-earners in society; it is also giving them a greater say in shaping society's will through the ballot box. It was this phenomenon that led the Swiss political scientist and theorist of democracy Silvano Möckli to suggest in a newspaper interview, that an age limit be placed on the right to vote and the right to stand for election – an idea that unleashed a storm of indignation across the political spectrum.

Pension systems are a product of crises and wars

Historically, the welfare state is rooted in two traditions: that of the authoritarian state and that of the cooperative. The authoritarian state functioned, and still functions, by keeping its subjects in check through a combination of stick and carrot, through benefits, regulations and taxes designed either to render them oblivious to their lack of freedom or to make them so used to having their minds made up for them that it becomes second nature. In this scenario the pension system is part of the disciplinary apparatus of the authoritarian state and a means of defence against socialist revolutionaries. Such was the thinking of Bismarck and Kaiser Wilhelm II. A cooperative is based at least partly on solidarity and this goes back to a form of "soldier's ethic" – or "soldier's dilemma" if we liken it to the classic "prisoner's dilemma" – namely, the imperative to survive while not abandoning one's comrades.

The Swiss social security system is likewise rooted in two traditions historically and socio-pyschologically. On the one hand it is a somewhat belated copy of the models in neighbouring countries, a product of crises and wars and a defensive strategy against unrest. On the other hand it has origins unrelated to the business of providing for the public in an authoritarian state, origins that lie in the notion, or myth, of group solidarity. Even the parties of the bourgeoisie in Switzerland have a deep-rooted tradition of public and political solidarity, which established itself particularly at municipal level. And via the municipal community, elements of "face-to-face" morality have been assimilated into the political environment. This is undoubtedly one of the reasons why social-democratic ideas inform political reality on a scale quite disproportionate to the vote for parties of the left (nowhere more than 30%). Since its inception, the current Three-Pillar Principle – and particularly the unfunded AHV element distributed on the "watering can" principle – has been actively supported and shaped by the middle classes as well as the rest of society.

Because its historical and socio-psychological roots thus lie in a cooperative sharing of costs and benefits, the "myth" of the AHV is currently in better shape than its finances. This complicates and hinders efforts at reform, for nothing is more resistant to change than a myth that has, until now, been handed down successfully in economic terms.

There are few countries in the world that have developed from co-operative and communal networks of solidarity in the way that Switzerland has, and this means that the Three-Pillar Principle – even if it were fundamentally sound – is not a model that could readily be generalised.

Is there a need to reconstitute the so-called "inter-generational compact" (which, of course, is nothing of the sort because no compact can be concluded with people who are not yet born)?

Sooner or later, in Switzerland as elsewhere, we will face the problem of having to find new solutions. At that point, belief in the financial dependability of social systems will play a crucial role. Those who believe in the durability of nation states and national taxation and redistribution systems will have faith in the ability of the pay-as-you-go system somehow to survive the demographic lean times. Advocates of European integration will believe in the extension of the welfare-state redistributive model to European level, although the prospect of centrally pooling various types of debt and risks of overindebtedness carries the danger of uncontrollably large credit exposures and is anything but reassuring. Those who are sceptical about centralisation and state provision will tend to put their faith in an increasingly prosperous global economy and properly functioning financial markets. And those who prefer to be self-reliant, and have the necessary resources, will buy their own homes (opting for self-sufficiency wherever possible), give their children the best possible upbringing and education, so that they can then look to them for support in their old age. Economists would call this investing in human capital and family-level social capital: it is another form of capital coverage and one which – seen in the global context of human history – has been relatively successful.

All of the foregoing tends to suggest there is a high level of willingness to retain the Three-Pillar Principle, at whatever cost. It can be assumed that the working population is under a great deal of pressure from the beneficiaries and potential beneficiaries of the system, in terms of expectations and discipline, and that the taxation system, the machinery of the law and the ideological forces that shape human consciousness will spare no efforts to keep the next generation in line – to compel them, more or less gently, to forego consumption and sustain the necessary level of pension contributions – while at the same time stemming the exodus of the wealthy, even if the price of all this is to restrict freedom under the rule of law. It is not so easy to slaughter a sacred cow. Even today this intermeshing of mutual demands and willingness to meet those demands in a national context is referred to as national social capital. It may be that pensions are actually that part of the basic consensus – or indeed of the oath cementing the national confederation in times of need – that is measurable in cash terms. It is impossible to predict whether the consensus will hold or the national pension system and the principle of pay-as-you-go will collapse (and if so, in what order). However, it is certain that if a collapse comes, neither of the two can survive for long without the other.

The machinery of the Three-Pillar Principle

The term "Three-Pillar Principle" may be familiar, but the machinery whereby it operates is still a mystery to many people. What follows is therefore a brief reminder of its main features.

By "First Pillar" we mean compulsory pension insurance – the Retirement and Survivors' Benefits Insurance (AHV) which is financed on a pay-as-you-go basis through a percentage levy on earnings. The minimum individual rate of pension is CHF 1000.- (about 700 USD) and the maximum around CHF 2000; this pension is payable for men from the age of 65 and for women from 62, with current political debate about the possibility of increasing the pension age for women and at the same time introducing greater flexibility. Everyone is entitled to this pension, irrespective of their means, in contrast to the so-called targeting system for payment of state old-age allowance, which is means tested.

The First Pillar is funded through a levy on earnings. All members of the workforce have to pay 10% of their earned income. In the case of workers other than the self-employed, half of the contribution comes from their employers in the form of a deduction from wages. Of course, in economic terms, this is also a proportion of the pay packet, so that the full 10% is compulsorily payable.

Because there is no ceiling on total contributions – even a person earning millions would pay 10% although his or her maximum pension would never exceed twice the basic rate of CHF 1000, i.e. it would not be more than CHF 2000 – the compulsory pillar of our pension system has a built-in redistributive function that has no equivalent elsewhere in the world. I mention this not as a merit but rather – in terms of the need to disentangle what insurance is actually for – as a considerable handicap. In a semi-direct democracy this sort of redistributive cornucopia is tremendously resistant to any attempt at moderating it. In the name of "solidarity" and at the expense of minorities, the majority has developed a system of security that is virtually immune to cutbacks, because none of the political parties can afford to take something away from the majority and because, in the political process, there is no lobby for long-term concerns.

The "Second Pillar" is the system of compulsory employers' insurance, the so-called occupational pension schemes (or pension funds), which are based on capital coverage. In conjunction with the AHV pension these schemes are intended to provide beneficiaries with a sum equivalent to 60% of their earnings on retirement. There are currently more than 10,000 independent pension funds, which are subject to statutory restrictions on their investment policy. A proportion of their assets may now be invested in home loans. Recently there has been a marked trend toward fund mergers, and legislation has been introduced imposing a system of mutual risk coverage by the various institutions. As institutional investors, the pension funds carry considerable clout on the capital markets, where their interest, on behalf of their policyholders, is in high yields (shareholder value). The security of their capital cover depends on medium and long-term trends in the international financial markets, and there are currently grounds for pessimism on this front. While the Second Pillar may constitute "private" insurance, it considerably restricts the individual's ability to dispose freely of his or her income, a factor that is not apparent if we look simply at the proportion of state involvement in pension provision. It leaves many young working people with children burdened and restricted at a time of their lives when they might wish to have their full income available to them; in return, when they reach pension age their income is high – for many, who have planned their lives sensibly in financial terms, exaggeratedly so.

The Third Pillar comprises personal savings invested at the individual's discretion, and in Switzerland, as elsewhere in the world, this form of cover is very unevenly distributed.

The basic pension of CHF 1000.- is not, however, enough to live on, so there is an additional safety net for pensioners who have no Second or Third Pillar pensions, namely the "AHV supplementary pension". This serves to close a gap in cover without recourse to actual social assistance payments, which are largely the responsibility of municipalities. A further safety net is also available in the form of the requirement under civil law to support relatives in need, while churches and private charitable organisations offer a solution of last resort. The AHV supplementary pension – to which there is legal entitlement although it is payable only subject to means testing – is an independent branch of the social security system, financed from tax revenue. In effect it can be seen as a further pillar which, in a departure from the "watering can" principle, ensures that those in greatest need (around 10% of pensioners) have a basic minimum on which to live.

The question asked in the title of my paper can be answered thus: I do not believe that in the foreseeable future a direct democratic decision will be taken in Switzerland on whether to dismantle, extend, or reform our three-pillar system. As a classical liberal, I naturally favour dismantling it and switching to a capital coverage system, but for the reasons outlined above I doubt whether my view – which I regard as the most sensible and socially responsible – could command majority support.

The existence of three pillars – the first mandatory and public, the second mandatory and private, and the third personal and voluntary – will delay the process of reform but will facilitate its gradual implementation.

If we include the supplementary benefits, there are actually four pillars; and in the case of the Third Pillar a distinction is currently made between the obligatory, tax-advantaged pension element and the free private pension element, so that in fact the correct number of pillars is probably five. This way of counting contradicts the principle of subsidiarity, which is something of an annoyance. Private, family-based old-age provision should surely be regarded as the First Pillar. It has been working – more or less – since time immemorial. The Second Pillar would then actually be a sort of insurance based on voluntary economic solidarity whereby the risk would be distributed by means of capital coverage; in this instance it is conceivable that this pillar could be declared mandatory – although there would be a free choice of insurer – as is the case today in Switzerland and as is also implemented in the "Chilean Model".

The Third Pillar would then be the state pension fund, which would link the idea of "pay-as-you-go" with the idea of redistribution; one could then pose the question as to whether it should operate on the "watering can" principle or should rather target a defined group of needy individuals.

The whole social security system in Switzerland, as in most comparable countries, is much more complex still. In addition to provision for old age and retirement there are other branches of social security e.g. mandatory disability insurance and unemployment insurance based on a percentage of wages, mandatory illness and accident insurance on the basis of individual contributions, combined with fairly complex taxpayer-subsidised procedures which affect approximately a quarter of contributors.

However, the whole business becomes even more complicated. In our three-layered structure of national governance there are in addition to the social institutions which exist at federal level a range of cantonal and municipal organisations. The state is also connected via subsidies on all three levels with private pension funds. Furthermore, there are many commercial offerings which benefit in one way or another from tax breaks which cannot be adequately represented in any overall economic calculation.

The decision-making processes in a semi-direct democracy have a strong plebiscitary element. In view of the large proportion of the population who are already of pensionable age or are beginning to think, feel and vote in these terms, and taking into account the fact that our system incorporates substantial, wholly unique redistribution effects from which a majority of the population are – or believe themselves to be – net beneficiaries, I would venture the following prediction: The eventual outcome will be a combination of the three strategies "dismantle", "extend", and "reform"; so the motto "Confusione hominum et providentia Dei Helvetia regitur" (Switzerland is ruled through the confusion of the people and by the grace of God) can also be said to apply loosely to the pension system. I personally am one of those sceptics who tend to rely more on the confusion of the people than on God's grace – particularly where the issue at stake is as delicate and wholly secular as social insurance.

Three conditions must be met if the confusion is to have positive effects. The constituency of the confused must not be too homogeneous, too centralised or too large. In the final analysis it must be based on a network of face-to-face relationships. Heterogeneity, non-centrality and smallness. All three conditions are met in Switzerland – perhaps it is here that we see evidence of "providentia Dei".

Complexity has obvious disadvantages and indisputable advantages. The more complex a system is, the less transparent it becomes. Complexity makes rational analysis and discriminating criticism more difficult and therefore also acts as a brake on any planned programme of reform. However, complexity also leads to immunity and robustness in an overall system.

Conclusion: development over the short, medium and long term

Under the Three-Pillar System reforms can take place only very gradually and by a process of trial and error. The danger that a single error or an unexpected situation could lead to irreversible damage is small. However, the chance that a more efficient system which provides improved benefits for all those involved could emerge within a reasonable timeframe – perhaps something along the lines of the Chilean Model – is also small.

The problem of sustainable pension systems must be seen in the larger context of the basic problems of democracy and the welfare state. In the longer term – and here I'm thinking of two or three generations – the welfare state as it currently exists will become untenable in Switzerland, even if its three pillars do undergo minor renovation and readjustment. The combination of untrammelled centrally administered democracy and the welfare state is simply not practicable in the long term. A majority of beneficiaries attempts to extend the range of state benefits and services in its own favour while the burden of financing these benefits and services is borne by a highly and progressively taxed minority. Both recipes enjoy almost limitless popularity, and the political proponents of redistribution continue to celebrate electoral successes on the back of this "solidarity via the money of others". The only antidote is a braking system implemented via direct democratic vetoes in conjunction with competing tax subjects which will slow down the machinery of intervention, control and redistribution and bring it to a stop. In Switzerland we have had some good experience in this area, but it is unfortunate that precisely this competition between the systems has been centralised in the case of the First Pillar of the social insurance at federal level and in the case of the Second Pillar institutionally linked by means of a risk balancing strategy between the pension funds.

Switzerland's problems with redistribution and the financing of the welfare state manifest themselves against a background of a high standard of living. This does not make them any easier to solve. We are socially secure, pampered and inflexible. As regards the readiness of the population to rethink and readjust to new technologies and global challenges, this is more than merely a handicap. Rich individuals and states can afford to misbehave economically for longer than poor individuals and poor states, but they will be hit all the harder when the time eventually comes.

Impressum

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