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A new chapter in German Pension Policy: The “2001 Pension Reform” based on a Paradigm Shift[1]

1. Introduction

Germany is one of the countries with the longest history of formal pension arrangements.[2] In the late nineteenth century the social (statutory) pension insurance was introduced (1889). However, schemes for civil servants had been established earlier, along with occupational pension schemes by a number of big companies. After the introduction of social insurance occupational pension schemes increasingly grew the character of supplementary schemes. Over time the existing schemes were adapted to changing circumstances and new schemes for several groups of the population were established. The fact that Germany has a very diversified “pension landscape” today can be explained just by looking at history.

As in the past, the environment a pension scheme is embedded in is changing today, and further changes are expected for the future. These are structural changes in the economy (especially in the labour market, the “globalisation” and the intensified international economic competition), changes in the age structure of the population (namely because of low fertility rates and increasing life expectancy), changes in the living arrangements and structure of households (e.g. smaller households, higher frequency of divorce), and changes in the structure of the life course like later entry into and earlier exit from the labour market as well as a longer life in retirement. But there are also changes in normative ideas (for example referring to the role of the state in social policy) as well as in arguments of the scientific community that became mainstream opinion.

It isn’t surprising that because of the changing environment and also because of the economic effects of pension schemes themselves there are various proposals for pension reform and also political decisions regarding scope, structure and design of pension schemes. If we only have a look at the time after World War II in Germany several important reform decisions were taken, mainly focused on the statutory pension scheme (which is by far the most important scheme regarding persons covered, expenditure and economic effects), but also for example in occupational pension schemes.[3] Political decisions in pension policy were made in Germany in 2001 once more, directly influencing not only the statutory pension scheme,

but also civil servant's pensions as well as occupational arrangements and private saving for old age. These were decisions regarding several instruments as well as the underlying objectives of the pension policy. They not only affect the public-private mix in pension arrangements but may fundamentally change the structure of the pension landscape in Germany if the recent political strategy underlying the reform measures remains effective for some time.

The paper is structured as follows: First, some remarks outlining the (organizational) structure of pension arrangements in Germany as it existed before the 2001 reform was decided are given. Second, which elements of the present pension arrangements will be affected by the new measures is explained. Third, remarks regarding the main arguments for the necessity of the reform decisions are made. Fourth, major elements of the reform as well as underlying objectives are discussed. This is done through contrasting the new rules to those that existed before. The measures regarding the social pension insurance are analysed, thereafter the new rules regarding occupational and private pensions. Fifth, some of the effects are outlined, although empirical evidence is scarce because not all reform measures have been implemented yet.[4] Nevertheless, some important tendencies can already be seen. Finally, the paper gives some reflections on the future development of the German pension schemes as well as on topics that will be on the political agenda in pension policy in the near future.

2. Short information on the organizational structure of pension arrangements in Germany

Since the late nineteenth century, a "multi-pillar approach" in pension policy has existed in Germany, an approach that is recommended world-wide.[5] Instead of "pillars" the German situation, however, can be characterized better by tiers (or layers).[6] In Germany there exist

– mandatory basic schemes as *first tier*;
– supplementary occupational schemes as *second tier* and
– additional private old-age provision as *third tier*.

The *first tier* consists of several mandatory pension schemes for specific groups of the population. Germany has no universal pension arrangement covering the total population. The most important element of the first tier as well as of old-age protection in Germany in general is the statutory (social) pension scheme insurance for blue- and white-collar workers. It is an earnings-related scheme. Pension calculation takes into account the *whole earnings*

career, and claims are accumulated on individual accounts. Pensions are paid in case of old age (there is some flexibility in retirement ages), disability and death of the insured person (widow's as well as widower's pensions and pensions for orphans exist). The scheme is financed by contributions (paid by employees and employers in equal parts) based on individual gross earnings up to a contribution ceiling (around 180 % of average gross earnings) and by expenditure from the federal budget.

There exist several other schemes beside social insurance for specific groups of the population. The pension scheme for civil servants is financed from public budgets of the federal, state and local level. This scheme is also of the defined benefit type, but pension calculation differs from social insurance pensions: civil servants' pensions are linked to *last* earnings. The pension is a certain percentage of individual last gross earnings according to the number of years of service. This pension scheme can be interpreted as an integrated scheme of elements of the first and second (occupational) tier. There also exist special schemes for farmers and several groups of professionals (like doctors, lawyers, architects).[7]

The *second tier* consists of supplementary occupational pension schemes in the private and public sector. While in principle all blue- and white-collar workers of the public sector are covered by an occupational scheme based on collective agreement, only about 50 % of employees in the private sector are covered by voluntary occupational pension schemes. There were hardly any collective agreements in the private sector for occupation schemes. This will be changing after the 2001 reform. Coverage in the private sector is distributed very unequally according to size and branch of the firm and (linked to this) also to sex of the employee.[8]

Typically occupational pensions are of the defined benefit type. In the public sector there still is an integrated scheme granting a specific percentage of last earnings by supplementing statutory pensions by occupational pension benefits of the public employer. For blue- and white-collar workers in the public sector occupational and statutory pension together result in a pension similar to the pension of civil servants. Therefore, this is also a final pay scheme based on two pension benefits.

In the private sector the voluntary arrangements result in a great variety of pension arrangements, mostly of the defined benefit type.[9] Financing is mainly by employers based on capital funding. There are also different organizational structures for occupational

schemes in the private sector, namely within the firm as well as outsourced by legally independent organizations.

Four different types of occupational schemes existed in Germany's private sector before the 2001 reform:

– *Direct pension commitment*s made by the employer and financed within the firm, based on book reserves. These are of special importance in Germany. In this case the firm itself is the pension institution.[10] More than half of all accumulated reserves in occupational schemes in the private sector are based on book reserves. This was an important instrument for internal (self-) financing of (big) firms particularly in the period of reconstructing the German economy after the Second World War.

– The *Pension Insurance Funds* (Pensionskassen) are legally independent institutions in the form of mutual insurance associations and are financed by the employer, but the employee can also contribute to the funds.

– *Support Funds* (Unterstützungskassen) are also legally independent institutions, mostly registered associations, financed by the employer only.

– In the case of *Direct Insurance* the employer is the policyholder and takes out individual or group life insurance for the employee. Financing is by the employer, sometimes supplemented by the employee.[11]

The 2001 pension reform is aiming at an extension of occupational pension arrangements especially by giving the employee a right to earnings conversion (see below). An additional type of pension arrangements is also introduced (as "pension fund"). In the public sector, the integrated final pay scheme for blue- and white-collar workers will be phased out in the future, while there will be reductions in benefits for civil servants in line with those reductions decided upon for blue-and white-collar workers in the statutory pension scheme. The implementation of these measures will be discussed later.

The *third tier* consists of many different types of private saving (including insurance) for old age. It is, however, difficult to give exact data on the amount of private old-age provision because even money from a life insurance contract can be used for other purposes than for financing living in old age. The borderline between second and third tier also becomes more and more blurred, for example by the already existing possibility of earnings conversion, i.e.

part of earnings can be converted (under certain conditions) into a pension claim. In this case the employer is not financing the pension claim. He is only a “broker” in arranging for example a group life insurance contract with lower costs compared to individual insurance contracts. A main objective of the 2001 pension reform among other things is to increase private pensions by subsidizing contributions. This can also be realized by firm-based arrangements.

It is important to note that *taxation* of pensions differs within the first and between first and second as well as within the second tier schemes. This has to be taken into account when comparing for example pensions of different schemes. Tax treatment also differs for different types of voluntary saving.

Some remarks were already made above regarding changes that are intended by the 2001 pension reform. Before discussing central arguments for and instruments of the recent reform, it should be mentioned that two new elements have been introduced into the German pension system that affect the organizational structure:

(a) *A means-tested transfer payment* in case of insufficient income for persons aged 65 and older as well as for the disabled. The benefit is calculated in the same way as means-tested social assistance, but with one major difference, children are not (as in case of social assistance) obliged to pay back the whole sum or part of it,[12] if their parents claim this new means-tested benefit in cases where their own income is below 100,000 EUR per year.

(b) The second new element is the already mentioned *subsidy for contributions for a private pension*. To become eligible, the private pension has to fulfil certain criteria in order to get a certificate that is the prerequisite for subsidies. The present coalition government (of Social Democratic and Green Party) labels this element as the “heart” of their concept for “modernizing” the pension scheme.

It is, however, astonishing that according to official statements of the government a capital funded private pension is introduced in Germany for the *first time*. The development of about one hundred years seems to be neglected totally. Today, a specific subsidy has been introduced, but even in the past there were special tax treatments in case of occupational pensions or life insurance contracts.

Social (statutory) pension insurance for old age, disability and widow(er)'s is by far the most important pension scheme in Germany in macro and micro-economic terms, as well as the source of income for the majority of the elderly.

Nearly 70 % of all expenditure for old-age security in Germany is by statutory pension insurance. This is nearly 10 % of GNP. More than 80 % of the West German population is insured in this pension scheme; in East Germany the percentage is even higher. For most retired people social insurance pensions are by far the most important source of income in old age. Public pensions are even more important for financing living in old age in East Germany.[13] Thus, it is not astonishing that the scientific and political debate in the past was mainly focused on the social pension insurance.

In Germany – compared to many other countries – the PAYGO financing in pension protection in absolute and relative terms is very high. Rough estimates show that about 80 % is by PAYGO, and 20 % by capital funding (occupational pensions and private provisions 10 % each). It is not surprising that there are influential groups are in support of changing this mix. The 2001 pension reform is aiming at an increase of funded occupational and private pensions and at a reduction of public (PAYGO financed) pensions.

3. Why another pension reform?

In the centre of the arguments for the recent pension reform was and still is the demographically induced future increase in contribution rates in PAYGO schemes which is expected not only in pension insurance but also in health and long-term care insurance. For pension insurance it is calculated that the contribution rate will increase from about 19 % today up to 24 % in 2030. These are figures from official projections of the government.[14] The burden for different "generations" (cohorts) was also used in the public debate as an argument regarding the increase of the contribution rate: Increasing contribution rates will *overburden* younger cohorts; "generational equity" needs a stable contribution rate over time. In addition, funded pension schemes will allow those who are able to save for old age to realize a higher rate of return compared to PAYGO pension schemes. Reducing the contribution rate in PAYGO scheme therefore increases take-home pay and enables employees to save more in funded schemes compared to a situation with a higher social insurance contribution rate.

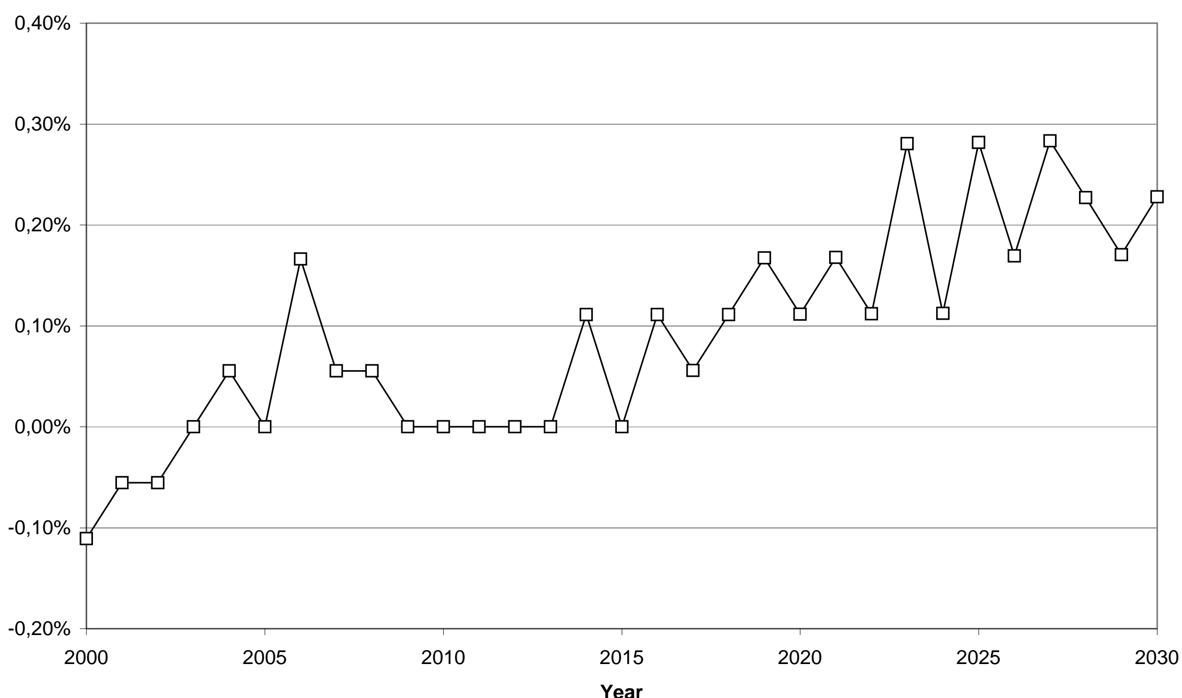
In evaluating the present as well as future contribution rates in the statutory PAYGO financed schemes several aspects should be taken into consideration:

(1) In an ageing population, especially if ageing is the result of an increase in life expectancy, old-age security becomes more expensive, regardless of the financing method.

(2) An increase in contribution rates, as mentioned above, takes place over time. When calculating how much increase in gross earnings is necessary to "compensate" for rising contribution rates in such a way that (at least on average) net earnings remain unchanged, then in Germany up to 2030 a growth rate of gross earnings of less than 0.2 % (0.3 % at maximum after the years 2020) would be sufficient in most years in order to compensate the increase in social insurance contribution rates that government presented in their official calculation for the coming decades (i.e. about 24 % in 2030); see Figure 1.

Figure 1

Rate of gross wage increase necessary to compensate an increase in the contribution rate (employee's part of statutory pension insurance) 2000 - 2030

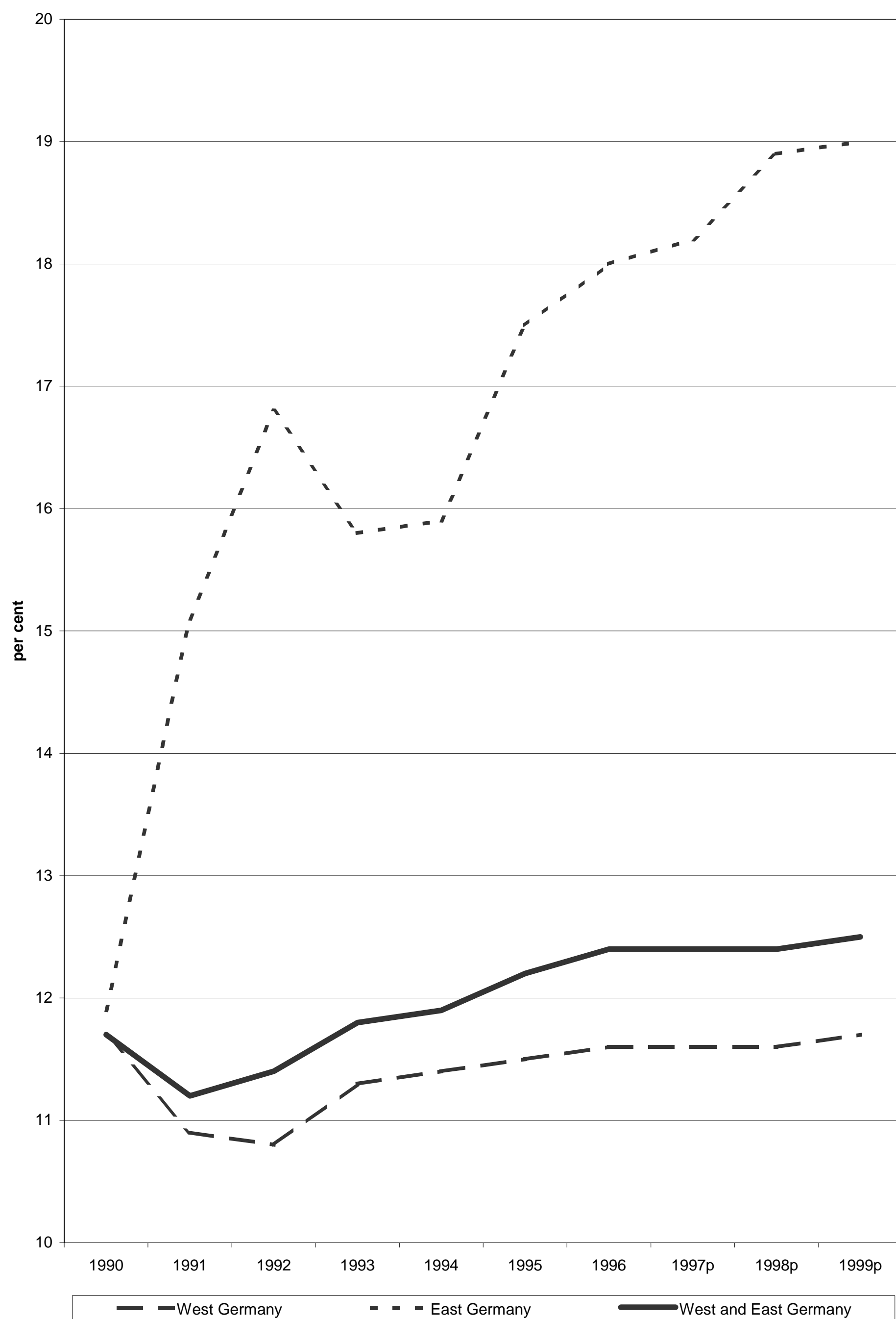


(3) It should be taken into account that the integration of East Germany into the West German pension arrangements during the process of unification caused an increase in the

contribution rate by about one percentage point. Figure 2 illustrates the fact that after unification pension benefits compared to GDP were by far higher in East Germany than in West Germany because of the difficult economic conditions, while for West Germany this ratio remained quite stable. This affected the contribution rate, which is calculated as an identical percentage for all contributors in West and East Germany. It is expected that the contribution rate will remain at a higher level for a great number of future years due to German unification.

Figure 2

Expenditure of Retirement and Survivors Pensions in per cent of GDP1990 - 1999, West and East Germany



Source: Based on data in Bundesministerium für Arbeit und Sozialordnung,
Social Budget 1999.

(4) Pension insurance was used for a long time as an instrument of labour market policy to induce early retirement without reduction of the full pension.[15] For example, about 50 % of all old-age pensioners in West Germany who retired in 1998 received a pension at age 60,

even 91 % in East Germany. Those retiring at age 65 (the "normal" retirement age) were only a minority;[16] see Table 1. The fact that "early" retirement could be realized without a reduction of the pension benefit increased the contribution rate, too, by about one percentage point. Although firms (and especially big firms) used different ways to induce early retirement to restructure and rejuvenate their labour force, the level of contribution rates is attacked especially by employers' organizations. The employers' part of the contribution is a major reason for high non-wage labour costs which has a negative impact especially on international economic competitiveness of German firms as well as in the competition with activities within the shadow economy on the national level.[17]

Table 1

Age when claiming an old-age pension in 1998
– in per cent of all old-age pensions –

Type of pension	West Germany		East Germany	
	male	female	male	female
in case of unemployment (age 60)	37.1	3.3	74.9	3.5
severely handicapped (age 60)	12.5	2.5	4.6	0.3
special retirement age for women (age 60)	–	47.0	–	91.0
total age 60	*49.6*	*52.8*	*79.5*	*94.8*
long insurance record (age 63)	23.7	4.2	13.6	0.5
at age 65	26.6	43.1	6.9	4.7

Source: Verband Deutscher Rentenversicherungsträger, Rentenversicherung in Zahlen 1999.

The reduction of non-wage labour costs is high on the agenda of politicians, employers' and industry's organizations. The 2001 reform is explicitly aiming at a reduction of the social insurance contribution rate.

There are demands to reduce public debt and balance the budget, not only but especially with regard to the Maastricht stabilization criteria of the EU. These criteria are an important political argument in the national debate regarding the reduction of public expenditure and shifting costs from public to private households. The minister of finance increasingly became an important player in pension policy. There are several reasons for this: The minister is under strong pressure to realize the Maastricht stabilization criteria; federal grant from the public budget to social insurance is a big part of federal public expenditure; the minister is also interested in a lower contribution rate because federal grant is (in its major element) also linked to the development of the contribution rate.[18]

The demands of reducing explicit public debt and "implicit debt" of PAYGO schemes often are based on a vague concept of "(inter)generational equity". This became one of the most widely used catchwords in German public debates. Especially the different rates of return of PAYGO and funded pension schemes were used as a major argument for gaining support of the "younger generation" for shifting from PAYGO to funded schemes.[19]

These aspects (whether empirically well-founded or not) were important in the public debate – a debate that was influenced and framed very much via mass media. "To fund or not to fund?" became the decisive question in a strategy to cope with the challenge of a "demographic pension crisis". It was even argued that such a crisis could shake the foundation of the German economy (Sinn and Übelmesser, 2000). The arguments of many economists in the recent public debate were far from being well-balanced.

The public debate was clearly framed towards substituting the "outdated" PAYGO scheme to a large extent by private capital funded pensions to establish a "modern" mix in financing methods. Reform measures *within* the PAYGO scheme were seen to be of minor importance.

According to the majority opinion in the public debate the major instrument to cope with the future challenges in pension policy was seen in a shift towards capital funding.[20] While in Germany the introduction of funded elements into a *public* scheme is refused in general, proposals for more capital funding thus are linked to proposals for privatizing at least a part

of old-age security. It is not surprising that the insurance industry, banks, investments funds highly favoured such reform strategies, which were also presented by several mainstream economists.[21] The interaction of different actors and the interests involved are a topic that still needs a closer analysis in order to explain the political process that finally resulted in the 2001 reform package.

The pressure towards capital funding was not only focused on *public* PAYGO financed social insurance and civil servant's pensions[22] but also on the biggest element of occupational pension schemes in Germany – direct pension commitments by the employer which are based on *book reserves*.[23]

4. The 2001 pension reform: a paradigm shift in pension policy

It would be an interesting topic to analyse the political process that finally resulted in the decisions of the 2001 pension reform. Here only the shift in objectives concerning pension policy and the instruments used to realize this shall be discussed. In order to show the differences in the new approach compared to the policy strategy of recent years, it is necessary to outline the design of the pension policy as it existed before the new decisions were taken.

4.1 The design of pension policy prior to the 2001 reform

In 1957 an earnings-related dynamic statutory pension scheme was introduced in Germany. This scheme was later adapted several times to changing conditions, especially by reform measures decided in 1989 which came into effect in 1992.[24] As already mentioned, the statutory pension insurance is the corner-stone of pension arrangements in Germany for the majority of the population. Occupational pensions are to supplement social pensions and private saving is an additional means for improving the economic conditions in old age.

The following characteristics of the social insurance pension scheme must be highlighted:

It is an *earnings-related defined benefit scheme*. Individual pension benefits are linked to former own earnings of the pensioner. The contributor acquires pension claims – in an individual account – according to the *relative* amount of his/her gross earnings compared to average gross earnings of all employees during each year of employment. If he/she earns just the average earnings in one year, then the employee gets one Earnings Point (equation 1).

$$(1)\quad EP_t = L_t^b / L_t^{db}$$

EP_t = Earnings Point in year t

L^b = (individual) gross earnings in t

L^{db} = average gross earnings of all contributors in t

At retirement the sum of individual Earnings Points of all years of insurance is multiplied by a factor representing the value (in German marks, now in Euro) of one Earnings Point. The result is the pension benefit per month[25] (equation 2).

$$(2)\quad R_t = \sum_{t=1}^{n} EP_t \bullet ARW_t$$

R = full pension benefit (per month) in Euro when retiring at an age when no deduction from the full pension is made (“reference retirement age”); otherwise reduction of 3.6 % per year of early retirement before this “reference retirement age”

ARW = (monthly) “value” in Euro of one Earnings Point

ARW is the dynamic element in the German pension formula. In 1992 the development of this factor was linked to the development of average *net* earnings instead of the development of average gross earnings which was in principle the rule for indexing pensions before. The rate of change of this factor is used for adjusting all pensions calculated in previous years (equation 3).

$$(3)\quad ARW_t = ARW_{t-1} \bullet (L_{t-1}^{dn} / L_{t-2}^{dn})$$

L^{dn} = average net earnings

Regarding the *distributional objectives* the idea of income or consumption smoothing over the life cycle is dominating and is implemented by a relatively close relationship between contribution payment (respectively the earnings being the basis for contribution payment) and pension benefits.[26] That means that above all intertemporal redistribution over the life cycle is aimed at by the design of the scheme and not interpersonal redistribution. Interpersonal redistribution within the pension scheme is intended to be financed by tax revenue (from the federal budget).[27]

There is now also a tendency in many of those countries with pension arrangements realizing to a high degree inter*personal* redistribution over the life cycle (like Sweden or Austria) to reduce these interpersonal redistributive effects and to realize a closer contribution-benefit link.

Within the German statutory pension insurance negative effects on pension claims of some *risks* like unemployment or illness (i.e., an interruption of paying contributions to the pension insurance) are in part avoided by contribution payments of other social insurance branches to pension insurance.[28] From the federal budget contributions are paid to statutory pension insurance for those periods that are credited in case of caring for children.[29] Contribution rates and pension calculation are identical for *men and women*, therefore this creates interpersonal ("intersexual") redistribution compared to voluntary private insurance.

In 1992 a clearly defined distributional objective regarding the *level of pensions* was introduced: Pensions shall always be a certain percentage of current average net earnings of all employees. This percentage depends on the number of Earnings Points. For example, a so-called "standard pensioner" with 45 Earnings Points should receive a pension benefit of around 70 per cent of net average earnings (equation 4).

$$(4)\quad R_t^E = 45EP \bullet ARW_t \approx 0.7 \bullet L_t^{dn}$$
$$R^E = \text{"standard pension" based on 45 EP}$$

For pensioners with a lower (higher) number of Earnings Points the percentage is proportionally lower (higher). Because pension adjustment rates were linked to the increase of average net earnings, the individual pension level remains constant over time because numerator and denominator are developing with the same rate of change.[30] This underlines its defined benefit type.

4.2 Reform measures of the 2001 pension reform to reduce

In 1997 the coalition government (Christian Democratic and Liberal Party) under chancellor Kohl already decided upon a reduction of the pension level.[31] This was very much attacked by the Social Democratic Party being at that time in opposition. The new rules did not

become effective because of a change in government in autumn 1998. Now the new coalition government of Social Democrats and Green Party declared that without reform measures there would be a “dramatic” situation in pension insurance because a contribution rate of about 24 per cent could be expected in the year 2030. This contribution rate – so the argument of the government – would not be accepted by the people. Therefore, government decided on lower target contribution rates: Up to 2020 contribution rate should not exceed 20 per cent and in 2030 it should not be higher than 22 per cent (instead of 24 % without reform measures).

Several measures will reduce the growth rate of pension expenditure in case of disability and retirement pensions as well as for widow’s/widower’s pensions. This will also reduce the contribution rate necessary to balance the budget. A major instrument in realizing the above mentioned contribution objective is a change in the pension adjustment formula.

4.2.1 Redesigning the pension formula

By redesigning the pension adjustment formula the benefit level will decrease in general. For example the pension level for a standard pensioner (45 Earnings Points) will be reduced from 70 per cent to 64 per cent in 2030.[32]

Regarding the pension adjustment formula the link to *net* average earnings has already been abolished: Particularly the effect of income tax changes was eliminated from the formula due to a change in tax policy aiming at a reduction in *direct* taxes and an increase in indirect taxes (value added tax as well as ecological taxes etc.). Reduction of direct tax burden increases pension adjustment rates if they are linked to net earnings development.

The new formula now links the adjustment rate to the development of gross earnings and changes in the contribution rate to pension insurance. Insofar government took over a proposal already published in the eighties by the author and proposed again at the end of the nineties by the Social Advisory Board of the German Federal government.[33] The intention of the formula is to keep down the increase in contribution rate which could burden contributors and pensioners (by lower pension adjustment rates).

However, government inserted an additional factor to this formula, a voluntary contribution rate which the government declares to be necessary because public pensions will not be sufficient to finance ones living in old age. Although nobody knows how much households

will save in reality, government integrated this private contribution rate into the pension adjustment formula (equation 5).

$$(5)\ ARW_t = ARW_{t-1} \bullet L^{db}_{t-1}\left(1 - b^{RV}_{t-1} - AVA_{t-1}\right) / \left[L^{db}_{t-2}\left(1 - b^{RV}_{t-2} - AVA_{t-2}\right)\right]$$

b^{RV} = contribution rate to social pension insurance

AVA = ficticious contribution rate for private pension (increasing from 0.01 to 0.04)

The fictitious contribution rate will be increased in four steps (every two years) from 1 per cent in 2002 up to 4 per cent of earnings in 2008. This will reduce the pension adjustment rate. Obviously this can be a powerful instrument for manipulating the pension level.[34]

Table 2 compares the elements of the previous and the now implemented formula for adjusting pension benefits.

Table 2

The Elements of the Pension Adjustment Formula

Elements of the Pension Adjustment Formula	
linked to average net earnings (1992)	new formula (2001)
development of	
average gross earnings	average gross earnings
employee's part of contribution in health insurance*) long-term care insurance*) unemployment insurance statutory pension insurance	full contribution in statutory pension insurance determined contribution rate in subsidized

	private pension

*) Pensioners paid own contribution. Therefore the effect of change in contribution rate is eliminated by a correction factor with the formula.

This reduction of the pension level will affect all present and future pensioners. But present pensioners as well as those contributors who are close to the retirement age have hardly any possibility to compensate the benefit reduction in social pension insurance by private saving (whether subsidized or not).

By reducing the pension level a conflict emerges. On one hand there shall be a close contribution-benefit link in statutory pension insurance, but on the other hand the general reduction of the pension level may result in such low pensions that even after a long period of paying contributions the pension benefit will not be higher than a full social assistance benefit which is at present 40 % of average net earnings. This may negatively affect the willingness to contribute and may undermine the acceptance for such a mandatory scheme based on earnings-related contributions. This argument will be illustrated by some figures.

Let us first have a look at the pension level of the Standard Pensioner (45 Earnings Points). Here the pension level will be reduced from 70 % to 64 % as a result of the new formula.[35] These percentages are only realized if retirement is at age 65 (which will be the reference retirement age in the near future). A reduction of 3.6 per cent of the full pension benefit is made per year of early retirement.[36] While today retirement is possible at age 60, in the future the earliest possibility to claim an old-age pension will be 62, equal for men and women.[37]

Table 3 shows for example that a pensioner with 35 Earnings Points retiring at age 62 has a net pension level only slightly higher than the social assistance level.[38]

Table 3

Social insurance pension as percentage of average net earnings
– standard pension level 64 per cent –

Earnings Points	retirement at	
	65	62
45	**64.0**	57.1
40	56,9	50.7
35	49.8	44.0
28.1	**40**	
31.5		**40**

It is thus possible to calculate how many Earnings Points are necessary to receive a pension just as high as (full) social assistance respectively the new means-tested minimum benefit for disabled and elderly persons introduced also by the 2001 reform (as mentioned above).

It is obvious that if the pension level is reduced, a higher number of Earnings Points is needed to receive a pension just as high as social assistance: At present (i.e. at a standard pension level of 70 per cent) a pensioner needs about 25 Earnings Points if retirement is at age 65. If in the future the standard pension level is reduced to 64 per cent, about 28 Earnings Points are necessary to get a pension just as high as social assistance benefit. And nearly 32 Earnings points are necessary if retirement is at age 62 (see again Table 3).

For a certain number of Earnings Points there exist several combinations of the relative earnings position a contributor has realized on average over the life cycle (i.e. average Earnings Points) and years of insurance (equation 6).

$$(6) \quad \sum_{t=1}^{n} EP_t = EP^d \bullet n$$

n = number of years of insurance

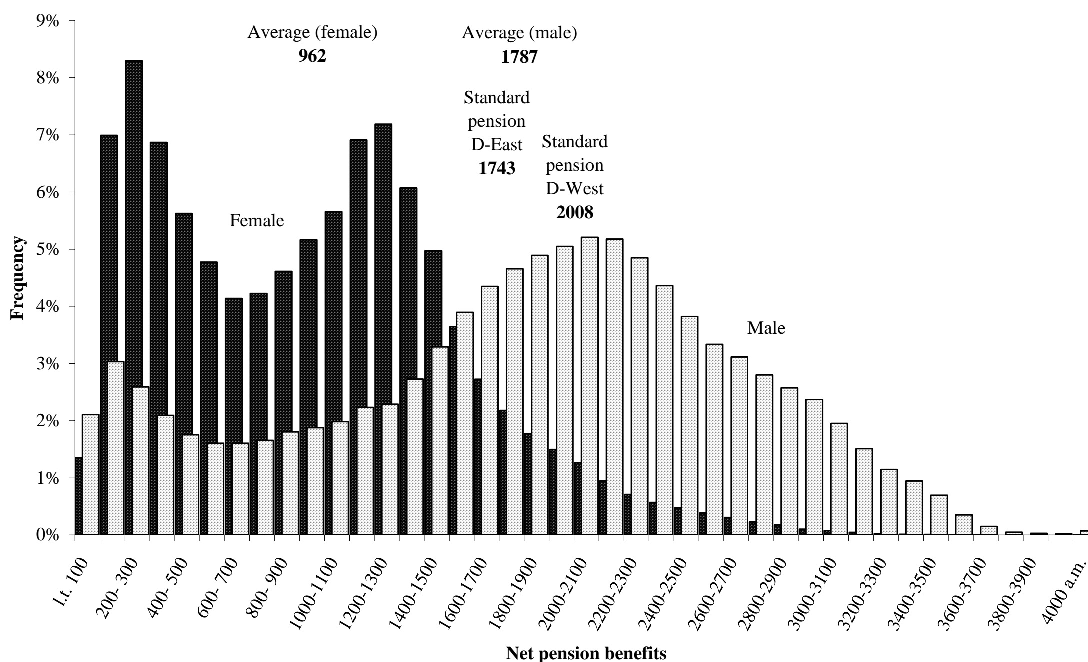
EP^d = Average Earnings Point the contributor accumulated during all years of insurance

Even today an employee with an average earnings position of 70 % (instead of 100 % like the average earner) – which is most often realized for women – already needs 40 years of insurance for a pension on social assistance level.

There exist remarkable differences in pension benefits between men and women, blue- and white-collar workers, workers in East and West Germany. Figure 3 illustrates this. The focus in public debate on the standard pensioner is highly misleading when talking about distributional effects, because today about 50 % of all men and 95 % of all women have a pension lower than the standard pension.

Figure 3

Distribution of net pension benefit frequencies (new old-age pensions*, 1999)



*contribution payments for health and long-term care insurance deducted.

Source: Own design based on VDR–Statistik (Rentenzugang 1999, CD-ROM), table 304.00 Z RV.

Looking at the new pension formula, it is obvious that the government can easily make changes in the parameter of the pension formula to further reduce the benefit level: The

fictitious contribution rate for private pensions can be increased above 4 % and the "constant factor" (in equation (5)) can be reduced below 0.9. Both would lower the adjustment rate and therefore the level of public pensions. The ideas to increase the fictitious contribution rate for private pensions were already mentioned by the Minister of Labour and proposed by government advisors.[39] It can be expected that such a development would undermine anew the confidence in the public pension and the acceptance of the public scheme.[40] It is not an unrealistic hypothesis that this is a hidden aim of some actors in the pension arena.

4.2.2 Other reductions of social insurance pension benefits

The above mentioned aspects referred to a general reduction of insurance pensions in case of old age as well as disability. Three areas shall be mentioned where benefits will be reduced in addition to this.

Regarding *disability pensions* additional changes were already implemented in the beginning of 2001.[41] Up to the year 2000 disability pensions existed in two types:
(a) Occupational disability ("Berufsunfähigkeit") and
(b) "Incapacity to work" ("Erwerbsunfähigkeit").
The first one was designed to compensate for a partial loss of working capacity in his/her occupation. Therefore, the pension is lower than (b) and it is assumed that he/she can take up a part-time position in a job that can be judged as "reasonable" considering the qualification of the employee. If there is no such possibility, the occupational disabled person becomes eligible for the (higher) pension as if there existed incapacity to work (b). Since the beginning of 2001 there are two degrees of a new disability concept related to the number of hours an applicant is able to work per day. If not able to work more than three hours, he/she is "fully disabled", between 3 and 6 hours "partially disabled", with a pension half as high as in case of being fully disabled. In contrast to former rules now all available jobs are considered as being "reasonable" irrespective of the former job or qualification of the insured person. The calculation of disability pensions is done as if the pension is claimed 3 years before the age for full pension. Therefore, a reduction of 10.8 % takes place. This became necessary because of the introduction of reductions from the full pension in case of early retirement. Otherwise incentives for claiming disability pensions would be operating. This is – but only partially – compensated by higher credits for insurance periods after disability.[42]

Widow's and widower's pensions are linked to the insurance pension of the former spouse. Therefore, the reduction in the benefit level of insurance pensions affects widow's/widower's, too. But the benefit level of widow(er)'s pensions is reduced even more because of the following two effects:
(1) Widow(er)'s pensions are a certain percentage of the insurance pensions of the former spouse. This percentage will be reduced from 60 to 55 per cent.[43] This reduces the pension in addition to the general reduction of the benefit level. While pensions for the insured persons will be reduced by 8.5 per cent because of the new adjustment formula, the reduction for widow(er)'s pensions amounts to 16.2 per cent because of the two effects.

(2) If the survivor's pensions is above an allowance, since 1985 an income test already exists which takes into account own earnings and own pension benefits of the surviving spouse. This income test will be extended to all kinds of income (except the new subsidized private pension). The allowance remains dynamic, i.e. linked to the development of average gross earnings. But the original plans of the government were to freeze the absolute amount of the allowance in nominal terms.

The reduction of widow's pensions is based on the normative approach that women should have sufficient own pension claims from earnings and additional credits for child care (today 3 Earnings Points per child are credited) and that therefore widow's pensions should be phased out in the future. Whether this is a realistic assumption for the coming decades in the light of female labour force participation (often on a part-time basis) is questionable.[44] And whether the new percentage of 55 will be further reduced or the parameters of the allowance will be changed remains an open question.

Because the calculation of the widow(er)'s pensions is based on an income test, the present way of financing these benefits (mainly) by earnings-related social insurance contributions can hardly be justified from a distributional point of view. Financing from general tax revenue would be adequate. Widow(er)'s pensions are about 20 % of total pension expenditure. Because of this volume at present no political force is interested in touching this topic. If widow(er)'s pensions would be financed in an adequate way from general tax revenue, this would make it possible to reduce the contribution rate to social pension insurance by more than 3 percentage points – that is more than the reduction in contribution rates resulting from the whole 2001 reform package up to the year 2030 (see below).

The unemployment insurance pays a contribution to social pension insurance in case of unemployment for those receiving unemployment benefits or – after longer periods of unemployment – (means-tested) unemployment assistance. Now the contribution payment of unemployment insurance to pension insurance for those who receive *unemployment assistance* is reduced, too. This means that especially the long-term unemployed will get lower pensions in the future, which reduces the burden of the federal budget, because these contributions are refunded by the federal budget.

These effects are affecting certain groups of the population in addition to the general reduction of the benefit level realized by the new pension formula. Up to now there is no differentiated analysis available showing the distributional effects of these measures (also in a life-cycle context).

4.2.3 Effect of the 2001 reform on the development of contribution rates

The present new rules in the social insurance pension scheme have only a moderate effect on the development of the contribution rate in social insurance up to the year 2030 (see Table 4): According to official projections, the necessary contribution rate in 2010 or 2020 is only one percentage point and in 2030 1.6 percentage points below the contribution rate necessary for financing pension benefits according to the “old” rules and their higher benefit level.

Table 4

<table>
<tr><th colspan="7">Contribution rates for Old-age Pensions</th></tr>
<tr><th rowspan="3">year</th><th colspan="2">contribution rates social pension insurance (in per cent)</th><th rowspan="3">additional contribution rate for private pension (in per cent)</th><th rowspan="3"></th><th colspan="2">“total contribution rate“ (in per cent)</th></tr>
<tr><th rowspan="2">without Pension Reform Act 2001</th><th rowspan="2">Pension Reform Act 2001</th><th colspan="2">share</th></tr>
<tr><th>employer</th><th>employee</th></tr>
</table>

2001	19.1	19.1	–	19.1	9.55	9.55
2002	19.2	19.1	1	20.1	9.55	10.55
2003	19.1	18.8	1	19.8	9.40	10.40
2004	19.2	18.9	2	20.9	9.45	11.45
2005	19.1	18.7	2	20.7	9.35	11.35
2010	19.5	18.5	4	22.5	9.25	13.25
2020	20.6	19.6	4	23.6	9.80	13.80
2030	23.6	22.0	4	26.0	11.00	15.00

Source: Bundestags-Drucksache 14/5146

Because the general federal grant[45] is linked to the development of average gross earnings and to the development of the contribution rate of *social* pension insurance, reducing the increase of this contribution rate also reduces the development of federal grant.

Regarding the payment of contributions by employees compared to employers there will be a shift because employees not only have to pay the employee's part of the contribution to social pension insurance[46] but in addition the full contribution rate for *private* pensions. This contribution rate is expected by the government to be paid by employees if they want to fill the gap in the benefit level that results from the reduction in public pensions. It is obvious that already from the beginning the sum of the two contribution rates is higher compared to the "old law". For example, in 2010 and 2030 the contribution rate in old-age insurance will be three percentage points above the rate compared to the former conditions (i.e. without these reform measures).[47]

Prior to the reform, a contribution rate of about 24 per cent was declared by the government to be too high (and as an indicator for a "demographic crisis") – now 26 (!) per cent is politically acceptable.

The reduction of employers' contribution[48] is, however, very moderate: eleven per cent instead of twelve per cent in 2030. That means that the effect on non-wage labour costs will be marginal. Although the burden for employees will be reduced by subsidies (see below), the partial substitution of public by private pensions will impose an additional burden on private households for a long time. These are the well-known *transition costs* when shifting from PAYGO to capital funding.

5. A first summary: Main elements of the paradigm shift

Before dealing with the new possibilities for private pensions introduced by the 2001 pension reform, the main elements of the paradigm shift which affect the statutory (social) pension insurance shall be summarized:

- A fixed pension level and financing (by contribution revenue and federal grant) as the dependent variable in social insurance were the explicit objectives decided in 1989 (implemented in West Germany since 1992 and in East Germany already in 1990). Since the 2001 reform, the development of the contribution rate now has become the dominating objective and the benefit level the dependent variable. It is a shift from an "expenditure-oriented revenue policy" towards a "revenue-oriented expenditure policy". It can be expected that in case the "contribution objective" of the present government [49] will turn out not to be attained, the benefit level will be further reduced. The new design of the pension adjustment formula opens an easy way to reduce the benefit level in social pension insurance.

- Subsidized private pensions are not just a supplement, but become a *substitute* for a part of the public pensions. This is obvious by the direct link of contributions for subsidized private pensions and the level of public pensions in the pension formula of the statutory pension insurance.[50] This partial substitute of public by private pensions also has as a result that funding in part shall and will substitute PAYGO financing.

In general, there are no truly convincing *economic* arguments in favour of the reform measures, if one looks at the officially mentioned objectives, for example the effects of

contribution rates. It was mainly a political reaction to expectations created in the public debate by several actors. Therefore, it seems to be above all a *political* project. But the reform will have several economic effects, for example on personal income distribution. This results from changes in public pensions as well as private and occupational pensions.

6. New rules for private and occupational pensions

It is the declared objective of the government to compensate the reduction in public pensions by additional private pensions.[51] This, however, is not possible anymore for those who are already pensioners or near retirement.

The original plan of the minister was to introduce a *mandated* private pension. The plan to mandate private pensions was especially attacked by a large newspaper. The political decision process was influenced remarkably. Government then decided to *subsidize voluntary* private pensions by incentives which are especially attractive for persons with low earnings and with children. These incentives are only given; if the old-age provision meets several restrictive criteria (see below).

Originally, there were no plans by the government for new incentives regarding occupational pensions. Reacting to pressures particularly by trade unions, saving in some types of occupational arrangements are now subsidized as well. In addition, several measures regarding occupational arrangements were decided upon. There now exists a *right* of the employee for conversion of earnings up to four per cent of earnings up to the ceiling for social insurance contributions (i.e. about 180 per cent of average gross earnings). While products for private personal pensions need a certificate, occupational pension arrangements do not need this in order to become eligible for subsidies.

In the following, first the private pensions and then the occupational arrangements will be outlined in their basic features. It has to be underlined that even now (in June 2002) there are a lot of open questions regarding important aspects of new rules, and there are still decisions made regarding changes in the design of measures. Above all there are no empirical data on how the new rules will affect the behaviour of those eligible to use some new instruments for saving in old age. And of course, there is no information on the effects of the new measures on income in old age.

When talking about private pensions and their role to compensate for a loss in public pensions, it has to be taken into account that private pensions are only for the purpose of financing one's living in old age, while the statutory pension insurance has also the task to provide transfer payments in case of disability and death of the insured person for the surviving spouse and children.

6.1 Private personal pensions with subsidies

As already mentioned, the loss in public pension benefits shall be compensated by voluntarily saving for old age. Fiscal incentives shall stimulate these savings. Saving products which can be chosen by the persons have to fulfil several (restrictive) criteria to get a certificate. This certificate is the precondition for becoming eligible for subsidies. These criteria – together with incentives – shall prevent some negative distributional effects. Here, only a few criteria will be mentioned:

- It is necessary to save regularly. But savings can be interrupted for example in case of unemployment or long periods of illness. Then, however, no pension claims are accumulated quite in contrast to the social insurance pension scheme (where health or unemployment insurance transfer contribution payments in favour of the ill or unemployed person to the social pension insurance).
- In principle, there has to be a guarantee of the *nominal* value of own savings, that means there is a nominal rate of return of zero. Therefore, no protection against inflation is guaranteed.
- The accumulated assets can be used when reaching retirement age or when claiming a disability pension. In principle, the assets must be paid out as a lifelong pension or as planned withdrawal up to the age of 85 and thereafter as a lifelong pension. With one exception, no lump-sum payments are allowed.[52] Otherwise the subsidy has to be paid back.[53] The criterion that saving must be in principle for a pension is the consequence of the aim that the private pension shall be a substitute for public pensions.
- No loans on assets are allowed.
- There are special requirements regarding the distribution of fees over a longer period (in most cases costs cannot be deducted from contributions in the beginning of the

contract), and requirements aiming at cost transparency as well as ethical, social and ecological aspects of investment.

There was and is much criticism concerning the regulation of the certified products. Especially negative effects on rates of return are often mentioned by the providers.

The supervisory authority for insurance companies gives the certificate for products. This only means that the product fulfils the criteria. It does not say anything about the quality of the product or the costs. Since the beginning of 2002 products with certificates have been offered by insurance companies, banks, investment funds. The decision on granting the subsidy is made by a new public office (which will have about 1000 employees).

Regarding the incentives in using certified products, there is a transfer payment (subsidy) or a tax exemption (a deduction from taxable income). The tax office will check which instrument is more favourable for the private households. Both elements aim at exempting the contributions for saving in these products from income tax (but not from social insurance contributions[54]). Interest on investments will be exempted from tax, while pensions will be fully taxed (EET). This differs from present rules for many types of pensions. At present, pensions from social insurance, from private life insurance and direct insurance are only partially taxed according to a real or fictitious return on former saving (for example at age 65 only 27 per cent of the social insurance pensions are taxable income).[55] The fact that the subsidized private pensions will be fully taxed in old age seems not to be recognized today, because nobody can make realistic assumptions on how income will be taxed 20 or 30 years from now. The dominating idea of this rule for taxation is that in principle saving for old age using this new instrument shall burden the private households less compared to other forms of saving which are not privileged (i.e. saving is from net income after tax).

The subsidy is especially attractive for persons with low income and for families with children, because there is an additional payment for children which is higher than the basic payment for (each) husband and spouse (see Table 5). The tax exemption is attractive for persons with higher income. The incentives will be phased in: The full incentives will be given from 2008 onwards in case four per cent of earnings are saved (if saving is less than the required percentage, the subsidy is cut proportionally).

Table 5

Subsidy in case of a private certified pension contract				
year	required contribution rate as percentage of earnings	transfer payment		exemption from income tax base (maximum)
		basic payment for adult persons	additional payment per child	
		Euro per year		
2002 and 2003	1	38	46	525
2004 and 2005	2	76	92	1050
2006 and 2007	3	114	138	1575
2008 and later	4	154	185	2100

It also has to be stressed that the transfer payment or tax exemption is counted as "own" saving – which goes into the individual private accounts. For investment the full sum of saving plus subsidy can not be used because costs have to be deducted. Although transparency of costs is required, the recent experience with saving products show that there is much "creative" work done in defining and hiding cost elements. In most cases it is impossible for the client to see in advance what the total costs will be.

Table 5 also shows that after 2008 there will be no increase in the nominal level of subsidies. This means that the value of the subsidy relative to own savings in case of increasing earnings over time is decreasing. In occupational arrangements (see below) there exists, however, a dynamic ceiling for subsidies.

Employees are now confronted with a huge number of different products. Suppliers offering certified products often see it as a possibility to "open the door" for additional products they want to sell. First experiences with misselling meanwhile have been reported.

There is an intensified competition between the different suppliers of certified products. It will be interesting to see how much will be saved via private pensions and how much via

occupational plans. Costs of employer-based arrangements can be expected to be lower compared to individual contracts.

6.2 New possibilities in occupational pension arrangements

One of the decisions of the 2001 reform package was to reduce the vesting period for pension claims based on payments of the employer from 10 to 5 years. Compared to other countries, the German vesting period was relatively long. And for a long time there had been a demand for its reduction especially regarding the effects on women who more often than men leave their job before the pension claim becomes vested.

As mentioned (in Section 2 of this chapter) there already exist four fundamental forms of occupational pensions and a great variety in the design of pension plans. In addition, some new possibilities for occupational arrangements were created. A new right for earnings conversion and the introduction of an additional type of occupational pension arrangements by establishing "pension funds" is of special importance. These measures shall stimulate the sluggish development of occupational pensions that has taken place in Germany for a number of years and shall especially extend coverage in the private sector.

Earnings not only up to 4 % of earnings but up to 4 % of earnings identical to the contribution ceiling in social pension insurance can be converted into an occupational pension claim, starting in 2002.[56] While for subsidized private personal pensions a contribution rate of (at the beginning) only 1 % and as of 2008 a contribution rate of 4 % is possible, the earnings conversion starts already in 2002 with 4 %. While for private personal pensions the subsidy will not increase after 2008 in nominal terms, the contribution ceiling for occupational pensions is linked to earnings development and therefore dynamic.

In case of earnings conversion, these parts of earnings are exempt not only from income tax (as in private pensions) but also from social insurance contributions. This is, however, only possible up to the year 2008. This possibility has several additional effects on the financing of social insurance and on the accumulation of individual Earnings Points in the social pension insurance: Earnings conversion without paying contributions on this amount will reduce the individual public pension in addition to the general benefit reduction. This effect has up to now hardly been recognized in the German debate.[57] And, of course, contribution revenue is reduced. This depends on how much earnings will be converted.

As mentioned in the beginning, there were hardly any collective agreements on occupational pension arrangements in the private sector. This is changing now: In a number of important industry branches (like chemical industry and metal industry) social partners have already negotiated on collective agreements based on the possibilities of earnings conversion. Because of the attractive conditions of arrangements via the firm or even a branch of industry compared to individual contracts (the lower costs and better information provided for investment) it can be expected that many employees will choose this way instead of a private personal pension. However, there are still no empirical data on how employees have decided.

There exist different types of incentives. They can be used in addition if persons can afford to save higher amounts. This already points at some distributional effects that will be discussed below. Employees are faced now with a great number of alternatives for subsidized saving for old age; see Table 6. Saving can be
(a) private saving – up to 1 per cent of earnings (2002) increasing to 4 per cent in 2008 – from *net* earnings in certified products and being eligible for subsidy or tax exemption (in Germany called "Riester" pension after the name of the Minister of Labour), or
(b) saving via conversion of earnings up to 4 percent of the contribution ceiling either in specific occupational schemes and becoming eligible for the subsidy or tax exemption (as in case (a)) or
(c) saving from *gross* earnings (exempted from income tax and social insurance contributions up to 2008) also in specific types of occupational schemes and
(d) saving in a direct insurance with a flat-rate tax of 20 per cent (instead of individual tax) and without paying social insurance contributions (up to 2008 and only in case that earnings conversion is not by regular elements of earnings, but for example holiday or Christmas allowance).[58]

Table 6

Alternatives in subsidized saving for old age

private saving	earnings conversion
(1 % (2002) up to 4 % (2008) of earnings)	(up to 4 % of earnings at the ceiling for social insurance contributions)

		– only until 2008
saving is in principle from net earnings (after tax and contributions), but eligible for (a) subsidy or (b) tax exemption	saving is in principle from net earnings (after tax and contributions), but eligible for (a) subsidy or (b) tax exemption	saving from gross earnings (exempted from tax and contributions)
if saving is in certified products	if saving is in direct insurance pension insurance funds pension funds	if saving is in direct insurance pension insurance funds support funds pension funds
new alternatives		

The decision process necessary for employers and employees is complex and difficult. And it is an attractive field for consultants. There are no empirical results available yet, because the new rules became effective only in 2002.[59]

It is not clear in how far employers will also contribute to pensions of their employees – which in the past was a specific feature of occupational pension schemes. Now there seems to be a clear tendency of private saving by employees themselves for old age (private pensions) via the firm. The focus of the 2001 reform is on those possibilities where the employee is directly saving, while those types of occupational pension schemes where only the employer pays for the pension (i.e. direct pension commitment and support funds) were outside the interest of government (Heubeck, 2002, p. 347).

Regarding the different organizational types of occupational pension arrangements beside the existing four types[60] a fifth type is established: *pension funds*. In contrast to existing forms these new funds have no cap on investing money in several types of assets. They can for

example invest 100 per cent in equities.[61] The establishment of such new pension funds started with delay because of delayed publication of specific rules.

Companies with direct pension commitments based on book reserves have got the possibility to outsource the pension liabilities without negative effects regarding taxation. This underlines the already mentioned aspect of bringing money from self-financing within the firm to the capital market.

Meanwhile, the collective agreement in the *public sector* was fundamentally changed: Instead of the PAYGO-financed integrated defined benefit scheme providing the employee with a certain percentage of last earnings as pension income from social insurance together with occupational pensions, in the future employees will only have the right to a defined contribution type of pension, that means no benefit level is guaranteed anymore.

7. Some lessons, implications and effects of the 2001 pension reform in Germany

The decisions and instruments used in the context of the recent German pension reform are aiming at a partial shift from

- (mandatory) public to (voluntary) private pension provisions,
- an expenditure-oriented revenue policy in the social pension scheme to a revenue-oriented expenditure policy,
- defined benefit to defined contribution schemes in general and in the occupational arrangements,
- PAYGO financing to capital funding.

This is done by a reduction of the benefit level in public schemes (social insurance and civil servants) and improving possibilities for private saving for old age on individual private accounts and via the firm. The state strengthens its role as the regulator in private arrangements and channels some additional tax money (transfers or tax expenditure) into the private market to stimulate savings for old age.

The new rules in pension policy in Germany have been enacted as of the beginning of the year 2002, some measures will be phased in during the next years. For a comprehensive evaluation of the reform measures it is much too early. However, some effects seem to be obvious and some others plausible.

The obvious present tendency is to reduce the benefit level in public schemes. Taking into consideration the development in many other countries, it is not astonishing at all that minimum elements become an integrated element in pension policy (the means-tested tax financed pension). Although private pensions as a substitute for public pensions are voluntary at present, the topic of *mandating* private (or occupational) pensions will be on the political agenda at least in case of a low participation of employees in the new possibilities for saving in certified pension products or in using the possibilities via collective agreements and/or in case the benefit level in public pensions will be reduced even more than declared today. Such mandating may be based on industry-wide collective agreements (quasi-mandating like in the Netherlands) or mandating by law (like in Switzerland). A combination of low public PAYGO financed pensions and mandatory private funded elements exists in many countries.[62] This is in line with a strategy which for example the World Bank is proposing world-wide (World Bank, 1994), although now with some modifications depending on country specific circumstances.

A further push towards reducing public PAYGO pensions can be expected from the European level. One influencing factor is the Maastricht stability criteria and the demand for reducing public debt as well as to balance the public budgets. One argument is the sustainability of fiscal policy and of pension policy and the need for intergenerational equity. These seem to be important political arguments. The focus here is mostly on reducing PAYGO financing (Schmähl, 2002).

Another influencing factor coming from the European level and also linked to the above mentioned aspects may result from the ongoing process of implementing an “open method of co-ordination” in pension policy for EU member states by deciding on common goals in pension policy and on a set of indicators being the base for benchmarking pension policy of the member states. This benchmarking will depend on the decision on which indicators will be chosen as relevant. Taking the important role of the ministers of economics and finance in the EU into account, it may happen that for example indicators like the percentage of public pensions over GDP will become decisive in the process of evaluating different pension arrangements in the member countries. It is obvious that the ministers of finance are especially looking at the “burden” for public households, not as much at the “burden” for private households if there is a shift from PAYGO to capital funding in private forms. The decision on the set of indicators will be decisive on how the pension arrangements in the

member countries will be evaluated. This process has not been finished yet, but it may become a highly important factor in the national pension debate and may influence the mix of pension schemes on the national level.[63]

Regarding the *public pension scheme* in Germany it seems not unrealistic to assume that in the near future there will be a further demand for reducing the benefit level, especially if the politically decided target contribution rate in social insurance is in danger not to be realized.

A further reduction of the benefit level would make the conflict between the pension level and the desired structure of the scheme even more obvious: will it be possible to politically realize a close contribution-benefit link in a mandatory scheme, if the benefit level is so low that a great number of employees even after a long period of contributing can only expect to receive a pension below or hardly above the social assistance level? The trend towards basic pensions with strong redistributive elements will then be a realistic assumption.[64]

While Germany today still is a country with an earnings-related public pension scheme (aiming at much more than only at avoiding poverty in old age by income smoothing over the life cycle) together with voluntary funded pensions (for example as the 2nd tier of supplementary occupational pensions), it may be not fully unrealistic that a shift in the 1st tier towards primarily avoiding poverty and in the 2nd tier towards mandating may take place – a pattern to be seen in many countries like the Netherlands or Switzerland. The development in these countries often is mentioned in Germany as an attractive model for pension policy especially by those actors aiming at an extended capital funded part of pensions.[65] It should be remembered that the present Minister of Labour originally favoured mandated private pensions and that this is proposed among others by persons from banking industry, consultants as well as advisors to the present federal German government.

Regarding *occupational pension* arrangements they already have become an important element in *collective bargaining* after the 2001 reform acts. For a long time trade unions were hardly interested in occupational pensions. Now, they discover this as a new field for activity in a period of diminishing influence of trade unions. This new interest of trade unions in collectively agreed occupational pension arrangements may be based on expectations regarding the influence on investment decisions of new industry-wide pension funds.

It can be expected that financing of occupational pensions in the future will be mostly by employees instead of employers as it was the case to a high percentage in the past. The tendency towards defined contribution schemes will shift risks from employers to employees.

The new strategy in pension policy in Germany will have a lot of important effects regarding social policy and income distribution. Whether the shift towards funded private pensions of the defined contribution type will result in adequate pensions in old age, remains an open question and depends on many influencing factors. For the effect on personal income distribution it is relevant who has the possibilities to save and to take up subsidies, what investment decisions will be made. Those who can afford to save can profit from the new (or additional) incentives. As already mentioned, there is also the possibility to use different types of incentives for private pensions and via the earnings conversion. This requires, however, that income is high enough to make use of several possibilities.

Persons with low income may not have enough money to save in these privileged types of saving. There is a remarkable percentage of German households (at present about nine per cent) that cannot meet their financial liabilities (their obligations to pay back the accumulated debt although they already reduced their living conditions). If they have some money left, it will be preferable for them to reduce the debt instead of saving in subsidized forms for old-age.

What is neglected today in public discussions is that these fiscal incentives have to be financed, too. If tax expenditure for incentives to save are financed mostly by indirect taxes (like VAT or tax on petrol etc.), all households and also households with low incomes have to finance the incentives while they are not able to profit from the subsidies. And also households with many children are burdened relatively high by indirect taxation. This reduces in fact part of the bonus they can get via the family-oriented design of the subsidies.

It can be expected that the distribution of income in old age becomes more diversified, or income inequality in old age will increase. This can be the effect of different participation in private pension funds as well as in different amounts of saving, but also in different net rates of return. For Chile, where the mandated private funds are operating since 1980, it is reported that the coverage is less than expected and that pension benefits can differ remarkably even for workers of the same age and with the same number of years of services and the same monthly income: “one receiving a pension amounting to one third of that of the other, merely

because they belong to different pension schemes".[66] This illustrates the assumption that more private voluntary pension arrangements substituting mandatory public schemes will result in an increasing income inequality in old age. This may be evaluated differently based on different value judgements, but should be recognized.

Concerning the development of saving it is an open question whether and how much *additional* saving can be expected. Based on the experience of former attempts to stimulate saving [67] there are severe doubts that the new financial incentives will increase total saving. It can be expected that there will be a high percentage of substitution within different types of saving from non-subsidized to subsidized types or towards higher subsidies.

Financial market actors recommend a shift towards types of saving based on equities. It is expected that saving for private funded pensions will fuel the stock market. As already mentioned, there was a great pressure from actors in financial markets towards a reduction of PAYGO financing as well as to reduce occupational pensions based on book reserves in favour of a shift towards capital funding. These attempts – supported by many politicians as well as academics and by the mass media – were obviously successful. But even after the new pension reform acts there are still demands for more activities into the same direction, even to mandate private pensions.

There remain many open questions regarding the effects of the new strategy in German pension policy. German pension arrangements are in the process of transition. It will be decisive whether in the future a further trend towards substituting public by private pensions will be realized. In this paper some arguments were given why this would change the character of the German pension scheme.

During the last years a biased political debate regarding the effects of different pension arrangements took place.[68] This influenced the political decisions or was used to gain some popularity for the new approach in pension policy by focusing the public attention on the subsidized private pensions. However, a long time will be needed until the effects of the new pension policy on the living conditions of the elderly become obvious.

Even after the 2001 pension reform act it is obvious that several topics remain on the political agenda. One is the taxation of provisions for old age and of pensions. Another is the development of the retirement age in public pension schemes. Demographic changes, labour

market development and the financing of social security will stimulate a discussion on postponing the retirement age for claiming the full pension.[69]

Perhaps Germany will soon have a frequency of pension reforms like in Japan, where every five years a reform is scheduled. It is, however, important that reform measures are based on a clear concept for developing this significant part of economic, fiscal and social policy that affects people during most of their life.

[1] The manuscript of this paper was finished in June 2002.

[2] In contrast to “formal“ pension arrangements informal arrangements are (especially) within the (often extended) family.

[3] An overview is given in Schmähl (1999a).

[4] That is June 2002.

[5] If I mention here the term ”multi-pillar“, this approach, however, is different from what the World Bank proposes more or less as a “blue print“ for pension policy, outlined e.g. in World Bank (1994).

[6] This terminology also better fits to the situation in many other countries. For a discussion of these terms see Schmähl and Horstmann (2002).

[7] A more detailed overview is given in Schmähl (1998a).

[8] A detailed analysis of occupational pension schemes and the link to social insurance is given in Schmähl (1997).

[9] The vesting period – 10 years – was relatively long compared to other countries. This was reduced to 5 years by the 2001 pension reform.

[10] There is a special mandatory insurance for employers to protect vested pension claims of employees in case of insolvency of the firm. Firms with direct pension commitments (as well as with support funds) are mandatory members of the Mutual Insurance Association (Pensions-Sicherungs-Verein). The contribution rate is about 0.2-0.3 % of the assets. For details see Heubeck (2000).

[11] For 1997 it was estimated that funds in occupational schemes to cover pension claims were about 531 000 million German Mark (DM). Regarding the different types of occupational schemes 56.5 % of the funds are in book reserves, 22.4 % in Pension Insurance Funds, 13 % in Direct Insurance and 8.1 % in Support Funds. The total volume of funds compared to GDP is 14.5 % including book reserves, 6.3 % without book reserves. Compared to macroeconomic weight of occupational schemes in the Netherlands, the UK or the USA Germany looks underdeveloped. However, this also reflects the quantitative importance of the social insurance pension scheme and the benefit level provided compared to the basic first

tier arrangements in the Netherlands, the UK or the USA. I will come back to this topic below. For a detailed analysis of occupational schemes and the links to the first tier pension schemes, see Schmähl (1997) with further references.

[12] Depending on income and assets of children.

[13] In East Germany, occupational pensions in the private sector as well as life insurance expenditure up to now have been hardly relevant. This means that social pension insurance in East Germany is even more important as an element of old-age protection than in West Germany today. Some reasons for this difference are the following: In the former socialist German Democratic Republic social insurance covered nearly the whole population. There existed some special pension schemes (e.g. for military personnel). After the German unification schemes for special groups of the population were introduced only step by step and the number of people of these groups (like self-employed, civil servants) increases only slowly over time. For some information regarding the pension arrangements in the former GDR see Schmähl (1992a).

[14] The assumptions used in such projections are, however, a matter of dispute.

[15] For details see Schmähl and Jacobs (1989), Schmähl (1992b), Schmähl et al. (1996).

[16] The relatively high number of female pensions in West Germany is due to the fact that these women were not eligible for a pension at age 60 and have in general very low pension claims.

[17] For a discussion of this argument see Schmähl (1995).

[18] This was introduced as an element of a self-regulating mechanism in 1992. For details see Schmähl (1993).

[19] Aspects that should be taken into account when comparing rates of return are discussed in Viebrok and Dräther (1999).

[20] There were different proposals on how much the ratio of PAYGO financing to capital funding should be changed from at present 80:20. Some argued for a ratio of 60:40.

[21] See e.g. Siebert (1998), Neumann (1998). Concerning this aspect Atkinson (1999), p.187, made the following general statement: “Calls by economists for rolling back the welfare state are themselves part of the political process; we have not just endogenous

politicians but also endogenous economists, whose behavior has to be explained“.

[22] Although changes in civil servant’s pensions took place there was hardly any major public debate on this. While in the years of making social insurance rules more generous civil servant’s pensions were the guideline. Now in periods of retrenchment civil servant’s pensions are adapted to reductions that were decided in social insurance.

[23] More than half of all funds accumulated in the four different types of occupational pensions are in book reserves. Two arguments mainly were put forward: Occupational pensions based on book reserves of the firm will be affected by demographic changes – a rising number of pensioners and lower number of employees – similar to public PAYGO schemes and secondly, the accumulation of capital within the firm (self-financing) is inefficient compared to the allocation of capital via capital markets. The three other types of occupational pensions are pension insurance funds (Pensionskassen), support funds (Unterstützungskassen) and direct insurance; for a detailed analysis see Schmähl (1997).

[24] The new rules became effective in West Germany in 1992, but some main elements were already in July 1990 introduced in the still existing German Democratic Republic (unification was in October 1990). The major elements of the 1992 reform are discussed in Schmähl (1993), the transformation of the pension scheme in the GDR in Schmähl (1992a).

[25] In case the beneficiary is eligible for the full pension without deductions in case of early retirement. These deductions (3.6 % per year) have been phased in since 1997.

[26] There is no general minimum pension, except an upgrading of pension claims under special conditions for contributors with many years of insurance but low wages. This especially favours women. The rules for the pension according to minimum income were changed several times since their introduction in 1972.

[27] It covers about 20 % of all expenditure of statutory pension insurance. In recent years several measures were taken to strengthen the contribution-benefit link by (a) redesigning expenditure (like introducing deductions from the full pension in case of early retirement), (b) reducing expenditure aiming at interpersonal redistribution (like crediting years of schooling, financing by contribution revenue), (c) financing redistributive expenditure to a greater extent by general tax revenue instead of contribution revenue. For an analysis see Schmähl (1998c).

[28] A detailed analysis is given in Schmähl (2001a).

[29] That is for three years on the base of average gross earnings.

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[30] In reality there are some differences because there exists a short time lag between development of average net earnings and pension adjustment rate.

[31] By introducing a so-called “demographic factor“ into the pension formula; for details and effects see Schmähl (1999a), pp. 107-114.

[32] The emerging income gap should be filled up by subsidized voluntary private saving that fulfils several criteria (see below). This saving rate will be phased in step by step (starting with one percentage point in 2002).

[33] The author was at this time chairing the Social Advisory Board. Regarding the origins of this proposal see Schmähl (1999b) with further references.

[34] In 2011 the formula will be changed in one parameter compared to equation (5). Instead of “1-“ the formula will read “0.9-“. The effect is a lower growth rate of pensions in case of an increase in the contribution rates compared to equation (5).

[35] Originally the coalition government intended to reduce the pension level even much more, however, differently according to the age of the insured person: The younger the contributor the more time is left for private saving. Therefore, the reduction is highest for the very young. And the original idea was to reduce the public pension by 50 % of the private pension the contributor could realize in case he in fact is saving 4 % of his earnings and receives an assumed rate of return. Such a concept – if realized – would change the public pension fundamentally: from an insurance benefit to an income- (pension-)tested transfer payment. For more details on this concept – which was in its pure form not realized because of strong resistance within the Social Democratic Party and by Labour Unions as well as by some academics and the Social Pension Insurance Administration – see Schmähl (2000a).

[36] This percentage is too low to avoid incentives for early retirement.

[37] In case of disability a reduction of 10.8 per cent is made (equal to retiring 3 years before the “reference“ retirement age).

[38] Whether such a person will receive means-tested social assistance depends, however, on the total income of the household.

[39] Also a majority of members of an Enquête-Commission of the Federal Parliament on “demographic change“ mentions this as an alternative for a further reduction in pension

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expenditure; Enquête-Kommission (2002).

[40] The public debate during the last years was – intended or unintended – an example how confidence and a feeling of security could be damaged. There was hardly any public debate about the empirical validity of the arguments as well as on alternatives to the strategy recommended by mainstream economists as well as finally by the federal government.

[41] For a detailed analysis of the old as well the new rules see Viebrok (2002).

[42] Now the period up to age 60 is creditied as years of insurance while before the years between age 55 and 60 only were credited by one third.

[43] For those who raised children a bonus is introduced as an element of family policy, however, financed from revenue of the pension insurance and not from the federal budget. The bonus is two Earnings Points for the first child and one Earnings Point for all other children. Whether this differentiation – that originally was not intended – will get approval at the Constitutional Court of Justice is an open question.

[44] For a discussion of pensions for women see the contributions in Schmähl and Michaelis (2000).

[45] It is by far the most important part of all transfers from the federal budget to the statutory pension insurance of blue- and white-collar workers. In addition there exists an additional federal grant linked to the development of VAT as well as to ecological tax revenue. These two elements were introduced to cover part of the pension expenditure aiming at interpersonal redistribution; for details see Schmähl (2001a).

[46] That is half of the contribution rate.

[47] Taking into account the subsidies or tax incentives in case of saving in specific types for old age (see below) the direct burden is lowered compared to the rates mentioned especially for low-income households. But these subsidies have to be financed, too, and can burden (above all if financed by indirect taxation) also these households. This will be discussed below.

[48] The question of shifting employers' contributions backwards to employees or forward into prices is not discussed here as well as the question whether trade unions will try to compensate increases in the private pension contributions by wage negotiations.

[49] Not more than 20 % in 2020 and 22 % in 2030.

[50] And it was even more obvious in the original plans published in May 2000, as mentioned above.

[51] Nevertheless government rejects the idea that private pensions in part substitute public pensions. The official announcement calls this a *supplement* to the public pension; see for example Riester (2002), p. 29.

[52] The exception is at maximum 20 % of assets at retirement age.

[53] This is also the case if the pensioner lives outside Germany. It can be expected that this will be brought to the European Court of Justice in case the pensioner lives in a country of the European Union.

[54] There exists, however, a specific possibility in case of earnings conversion. These earnings are also exempted from social insurance contributions, but only up to the year 2008. This will be explained below.

[55] On March 6, 2002, the Constitutional Court decided that the present rules for taxing social insurance pensions are in conflict with the constitution. There has to be a change by the end of year 2004. It can be expected that reforming social insurance taxation will affect all types of provisions for old age.

[56] The contribution ceiling is about 180 per cent of average gross earnings. Therefore, saving of 4 per cent of earnings at the ceiling is 7.2 percent of average earnings.

[57] Only for those employees with earnings above the ceiling this exemption of private saving from contribution payment does not affect the Earnings Points in the year because they get only the maximum Earnings Points (1.8) in one year. For the part of earnings above the ceiling no social insurance contributions have to be paid, but Earnings Points can not be accumulated either.

[58] This possibility also exists for saving in a pension insurance fund, however, only if exemption from tax and contributions is exhausted by saving in a pension fund or a pension insurance fund.

[59] Newspapers reported that about 3500 products were certified in February 2002 and 1.5 million saving contracts existed as well as 300 collective agreements covering in principle

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more than 15 million of employees who are eligible to use the existing possibilities (Süddeutsche Zeitung February 13, 2002). But there is no information how many employees used the possibility.

[60] Direct pension commitment (based on book reserves); pension insurance funds; support funds; direct insurance, see Section 2 of this chapter.

[61] While, for example a pension insurance fund can invest up to only 35 per cent in equities.

[62] An attempt of a typology was already published in Schmähl (1991).

[63] For more aspects concerning this process see Schmähl (2002).

[64] For a detailed discussion of these conceptual aspects see Schmähl (2001b).

[65] For example the basic tier (AHV) in Switzerland often is mentioned because it covers the whole population and is highly redistributive because of earnings-related financing but only little difference between lowest and highest pension (100 per cent). It is neglected that the aim of avoiding poverty is realized much less by the AHV compared to the earnings-related social insurance pension in Germany. And it is often neglected, too, that occupational pensions are mandatory.

[66] ILO (2001).

[67] See Börsch-Supan and Essig (2002), p. 93.

[68] This is discussed in Schmähl (1998, 1998d and 2000b).

[69] Proposals how to react in PAYGO pension schemes to increasing life expectancy are discussed in Schmähl and Viebrok (2000).