

# **New developments and future directions of the Public Pension System in Germany**

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### **1 Foreword**

This contribution is in part a revision and in part an extension of an article written at the end of 1998 and published under the title "Public Pension Reforms in Germany - Major Post-War Reforms and Recent Decisions" (Schmähl 1999). I will refer to this paper and not include this material at length into this article.

A special focus is on the aspect of the ageing population and its consequences for the German pension scheme as well as on developments that took place during the year 1999. Finally some remarks concerning possible future developments will be made - taking into account new political considerations at the end of 1999, when this paper was finalised.

### **2 Main challenges for the public pension scheme**

#### ***2.1 General remarks***

As outlined elsewhere there are many reasons for reform debates in Germany because of changing conditions in the national economy, in demography and household structure, but also from intensified international competition and from changing ideas about the role of the state in pension policy. Especially actors of the financial markets are much more active in pension policy debate compared to former decades. There are in addition specific German challenges, at least in their extent like the high unemployment rate, partly linked to the still ongoing process of the German integration. Also the framework of the monetary union in Europe, e.g. the restriction on budget deficits, is of importance in the political process of decision making in pension policy which is closely linked to public finance.

A special focus in public debate in Germany is on the ageing of the population, resulting from a low fertility rate (which is for a long time only two thirds of the number necessary to hold the population number constant over time) and a rising life expectancy. The decrease of mortality is now put in the centre of the debate concerning demographic changes and their effects for pension policy (as well as health insurance and long-term care insurance). Therefore such facts especially concerning the development of life expectancy are integrated in this report.<sup>1</sup>

#### ***2.2 Development of the old-age dependency ratio with special emphasis on the development of life expectancy in Germany***

Old-age dependency ratios are often used as an indicator for an increasing "burden" in ageing populations. Table 1 shows a remarkable increase in this ratio (with age groups delimited at 65+/15-64) in between 1960 and 1997 for many of the European OECD Countries.

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<sup>1</sup> This is in part based on an unpublished paper of Schmähl and Viebrok (1999).

It is well known that the reasons for this increase can be found in two processes: The rapidly declining fertility rate at the end of the 1960's and the decreasing mortality especially of older persons, resulting in higher life expectancy. In order to get a comparative figure for old-age dependency ratios, we can use the age-specific mortality rates to calculate an imaginary stable population and then derive old-age dependency ratios from that population. This is done in Figure 1, based on the life table 1991/93 for West Germany.

**Table 1: Old-Age Dependency Ratios\*\* in European OECD Countries**

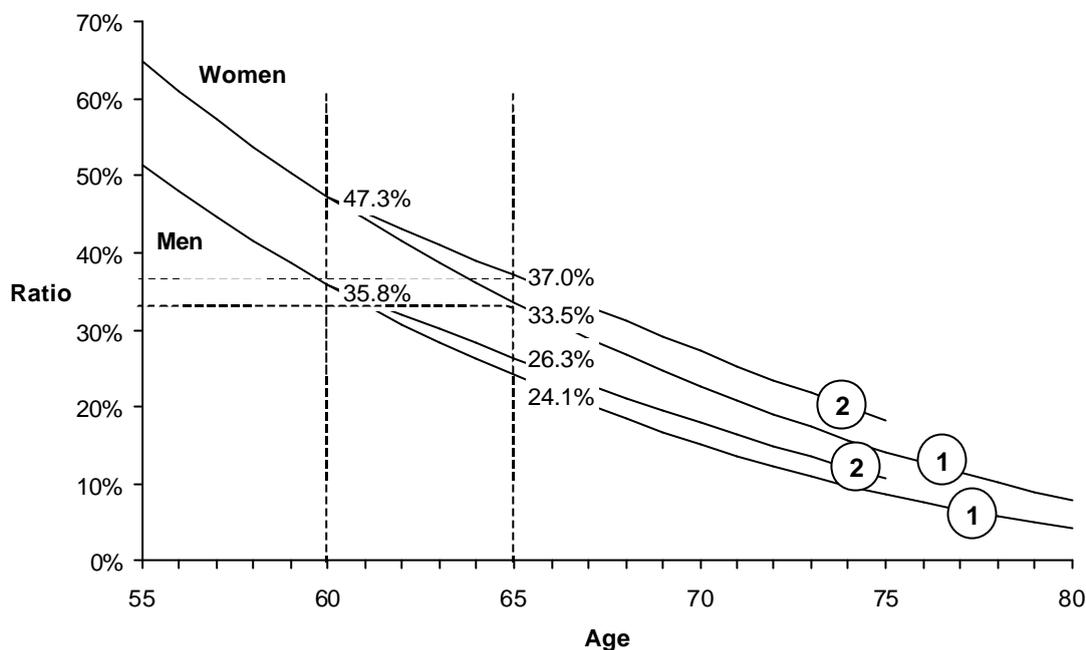
Country*	Population in thousands	Growth rate in %	Old-age dependency ratio** in %		Notes
			1997	1997 / 1996	
Turkey	63 745	1.7	6.7	7.8	
Poland	38 650	0.1	-	17.3	
Ireland	3 661	1	18.6	17.4	
Iceland	272	0.7	14.2	17.7	1996 instead of 1997
Czech Republic	10 304	-0.1	15.8	19.6	
Netherlands	15 609	-1.4	14.8	19.6	
Luxembourg	424	1.4	15.9	21.2	
Hungary	10 155	-0.4	-	21.2	
Finland	5 284	0.3	11.7	21.7	
Portugal	9 950	0.2	-	21.9	
Switzerland	7 087	0.2	15.4	22.3	
Denmark	5 140	0.4	16.5	22.4	
Italy	56 868	0.2	13.3	22.8	14-64
Austria	8 072	0.2	18.6	22.8	
Spain	39 323	0.1	12.7	23.3	
Greece	10 498	0.3	12.3	23.4	1996 instead of 1997
France	58 608	0.4	18.7	23.7	
Germany	82 061	0.2	15.9	23.9	1960 West Germany only
United Kingdom	59 009	0.4	18.0	24.2	
Norway	4 393	0.5	17.2	24.5	
Belgium	10 181	0.1	18.6	24.7	1996 instead of 1997
Sweden	8 848	0	17.9	27.8	16-64
EU-15	373 474	0.2	-	23.4	
G7	679 790	0.5	14.4	21.1	
OECD Total	1 093 792	0.6	-	18.9	

Source: OECD 1999, p. 6-7 (database: OECD Labour Force Statistics).

\* Sorted by ratio in 1997 - Population level and growth rates are shown for additional information.

\*\* defined as 65+/15-64

**Figure 1: Ratio of total remaining years to passed years (from age 15 on) of all cohort members, calculated at cohort age, according to life-table 1991/93**



Source: Own calculations based upon data of Statistisches Bundesamt 1995

In Figure 1, two different types of ratios are calculated, using the age on the x-axis as the borderline between the age groups in numerator and denominator: ① the ratio of remaining years at this age compared to passed years (since age 15); ② in addition starting at age 60 the ratio of remaining years to the years from 15 up to 59 (i.e. a fixed span as denominator).

We can see from the comparison of the ratios in Figure 1 with the ratios in Table 1, that mortality leads to relatively high dependency ratios even in a stable population. Under these assumptions the old-age dependency ratio delimited at age 65 (i.e. age classes 65+/15-64) would be 24.1% for men and 33.5% for women in Germany (see Figure 1).

These “steady-state” ratios are higher than the empirical ratios in Germany today, but substantially lower than predicted for the future. Table 1 shows for Germany a combined ratio of 23.9% for men and women in 1997. According to own calculations (based on data of Enquete-Kommission 1998: 114), the old-age dependency ratio at age 60 (60+/15-59) will increase from 38% (women and men) in 2000 up to 61% in 2030 and 63% in 2040, whereas the stable ratios at age 60 are 35.8 and 47.3, respectively (see also Figure 1).

Choosing an higher age for the threshold between working period and old-age for the calculation of the old-age dependency ratio leads of course to a lower ratio, e.g. at age 65 33.5% for women instead of 47,3%. But if we additionally assume that the working period is fixed (lines ① in Figure 1) instead of being varying with this threshold age (lines ②), the resulting difference with respect to the ratio is only relatively small compared to the expected development of the old-age ratio until 2030. At age 65 the difference is 3.5 percentage points

for women and 2.2 percentage points for men.

The development of the population structure is of course only one of the determinants that affect the budget of a pension scheme. For financial considerations the old-age dependency ratio is less relevant than the ratio of the number of beneficiaries (pensioners) to contributors (“pensioner ratio”, “systemic dependency ratio”). Especially the labour force participation rates and their changes result in important differences in both variables. But also the development of average pensions and average wages changes over time. These two variables are also significant for the financing conditions of the pension scheme. For example, because of the growing number of insured women due to changes in labour force participation, an increase of average female pension claims is expected. On the other hand, women are often employed on a part-time basis. Therefore, more part-time employees and lower average monthly wages can be expected. These processes are changing the structure of pension benefits. The question whether a higher number of pensioners results in higher pension expenditure depends amongst other things on how pensions are calculated (for example whether part-time employees get less pension claims or not)<sup>2</sup> and whether the pensions are adjusted to the development of average wages or not.

**Table 2: Life Expectancy at Birth and at Age of 65 in West-Germany 1960-1995**

Life table	At birth		At age of 65	
	Males	Females	Males	Females
1959/60	66.69	71.92	12.38	14.37
1993/95	73.53	79.81	14.79	18.57
	Change in percent			
1960/95	10.3	11.0	19.5	29.2

Source: Enquete-Kommission (1998: 45, table 14).

For Germany, the association of the German statutory pension insurance agencies (VDR) calculates a “standardised pensioner ratio”<sup>3</sup> in order to eliminate the effects of such structural changes. This ratio is expected to rise from 42.5 in 2000 up to 60.6 in 2030. This is an increase of 43%, whereas the demographic old-age dependency ratio is expected to increase much more in Germany if one uses the definition (60+/15-59) of the ratio (see above). According to the German Ministry of the Interior (Bundesministerium des Innern, without year) this ratio will increase from 40.9% in 2000 to 73.2% in 2030, an increase of about 80%.

Investigating the effects of increasing life expectancy it is important to know in which age segment a decrease of mortality takes place. For a long time, an increase of the average life

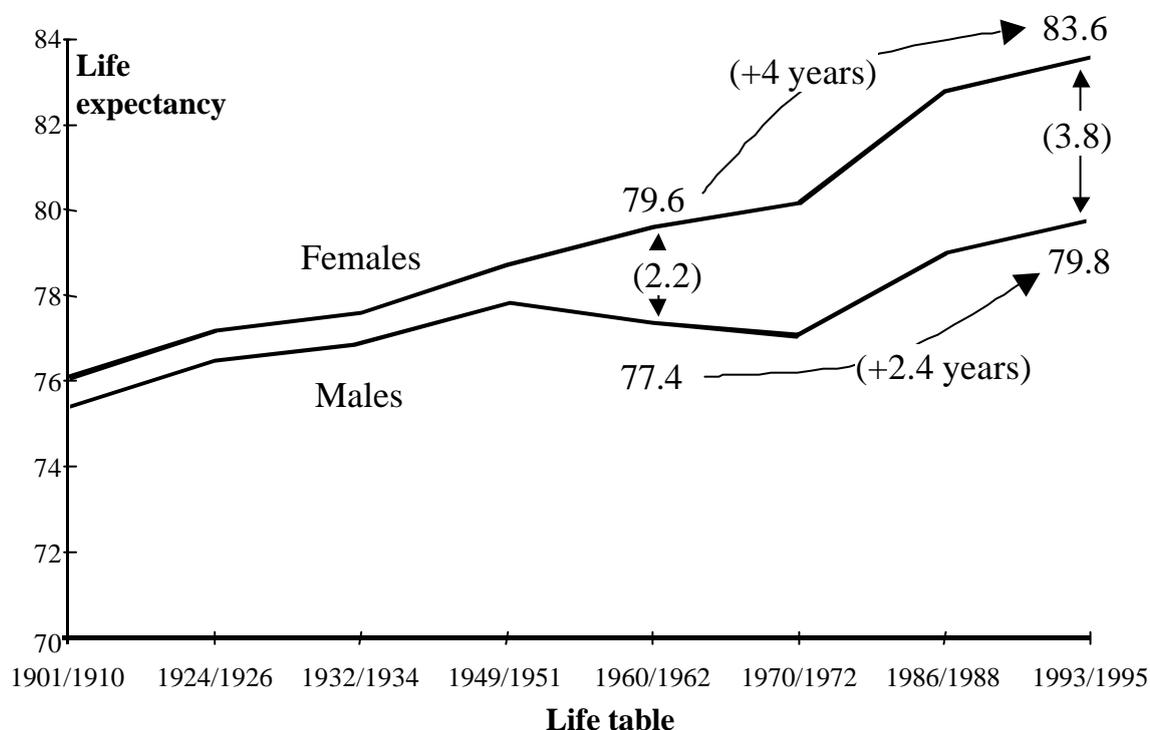
<sup>2</sup> In Germany, pension claims depend on “earnings points”, which are calculated as the ratio of individual insured earnings to average earnings per year. Hence the total number of earnings points created in one year equals the number of insured people.

<sup>3</sup> The “standardised pensioner ratio” is calculated by dividing the total pension expenditure by a so-called “standard pension”. This is calculated as a pension of someone, who got average earnings during 45 years of insurance. Hence the term „standardised pensioner ratio” describes how many imaginary „standard pensions“ have to be financed by 100 workers.

expectancy (at birth) was achieved - amongst other things - by a decrease in infant and child mortality. In recent time, an increase in life expectancy is above all a result of a decrease of mortality rates in old age. This is illustrated by data for West Germany. The life expectancy at age 65 has increased relatively much more than the (average) life expectancy at birth (see Table 2). This increase in the life expectancy of elderly has mostly been underestimated in the past.

Especially during the recent two decades, the increase of further life expectancy of elderly persons was remarkably higher than in the previous period since the turn of the century. This is shown in Figure 2 as an example for the life expectancy of persons aged 65.<sup>4</sup>

**Figure 2: Development of Life expectancy at Age 65, West Germany**



Source: Statistisches Bundesamt (1997: 76).

Not only the increasing life expectancy in general but also the higher difference in the life expectancy of both females and males affects the financial situation of pension schemes,

<sup>4</sup> These data are based on cross-sectional mortality tables and refer to West Germany (1949/51, without the Saarland, however). - Life expectancies in East Germany were and are below those in West Germany. Changes also arose in the situation after the unification: "A comparison of mortality in the East and West of Germany prior to and after the unification shows a divergence of life expectancy for men up to age 50, while the differences in life expectancy for women decreased"; Sommer (1996: 18). A comparison between East and West Germany for the period 1950-1995 is given in Enquete-Kommission (1998: 46, Fig. 5). In general, an approach of the life expectancies in East and West is expected in the medium and long run with the alignment of living conditions.

because not only (*ceteris paribus*) the average duration of contributors' pensions increases - but also of survivors' pensions.

In West Germany around 1960, the expected age for women aged 65 was 79.6 years on average, the further life expectancy thus was about 14.5 years. It increased by additional 4 years to 18.6 years until the mid-nineties. Life expectancy for men is clearly lower. Moreover, the difference in (average) life expectancy of men and women even increased during the recent decades: Around 1960 it was 2.2 years, while in the middle of the nineties the life expectancy of women aged 65 was now 3.8 years above that of men.

An increasing life expectancy of the elderly is assumed in the population prognoses for example for Germany. The assumptions are mainly orientated at the fact that in many other highly developed countries a significantly higher life expectancy has been reached already now. On the other hand, one should not forget that expectations concerning the future are often strongly shaped by the developments of the recent past.

In Germany the present life expectancy data for older persons in Japan are assumed as "target values" for the further development of life expectancy during the next decades: The calculation of the development of pension expenditure (for the Social Advisory Council of the German government and based on data used of the Federal Ministry of Labour and Social Affairs of November 1999) is based on the assumption that life expectancy of men will increase from 15 to about 17 years (in 2030) and of women from about 19 to 21.6 years. It can be expected that the population projection of the Federal Statistical Office which is just prepared for publication will use about the same data.

### **3 The present structure of the public pension scheme (social insurance) in Germany and some important steps in its development**

In Schmähl (1999) an overview is given over the present structure of old age security arrangements in Germany. It was outlined that social insurance for old-age, disability and widow(er)'s is by far the most important scheme

(a) in macroeconomic terms<sup>5</sup>,

(b) as well as source of income in old age for the majority of the elderly in Germany.<sup>6</sup>

Recent research, trying to analyse the pension claims for cohorts retiring during the next twenty years shows, that these in principle will also remain unchanged during these years. Therefore it is not astonishing that the scientific and political debate was and is mainly

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<sup>5</sup> It is paying nearly 70 % of all expenditure for old-age security in Germany. Expenditure of social pension insurance 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.

<sup>6</sup> In East Germany occupational pensions in the private sector as well as life insurance expenditure are up to now hardly relevant. That 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.

focused on the social pension insurance. This was also the case in 1999.

To understand the present discussion a short remark concerning the first major pension reform in post-war Germany of 1957 seems necessary. The "*dynamic pension*", linking pension calculation as well as pension adjustment to the development of gross wages (earnings), was introduced. This was accompanied by a major shift in the method of financing towards PAYGO. Since 1992 only a minimum reserve requirement of expenditure for one month is necessary.

In Germany - compared to many other countries - the PAYGO financing method in pension protection has a very high weight in absolute and relative terms. Therefore, a discussion is going to supplement this to a higher degree by funded elements. However, the way of how to realize this, is under dispute and will be discussed later.

Also important for today's discussion is the design of *flexible retirement ages*. Since 1972 men can retire before the former reference retirement age of 65 already at age 63<sup>7</sup> *without actuarial* deductions from the pension. This favourable conditions existed also for women and unemployed persons - retirement age 60 under special conditions.<sup>8</sup> This gave incentive to early retirement - although other factors, like labour market conditions, were also influencing the average retirement age which is around age 60.

Another corner-stone of the present design of the social insurance scheme is from 1992 (Schmähl 1993b): After several ad hoc interventions in the mechanism for adjusting pensions to gross earnings (which in principle existed since the end of the fifties) a political aim was to establish again a set of clear rules, a self-regulating mechanism to stabilize the financing development over time and to reduce the financing burden for the working population in the future, while on the other hand an appropriate level of pensions compared to earnings should be maintained. Concerning the adjustment mechanism, since 1992 pension adjustment rates have been linked to the increase of average net earnings instead of average gross earnings.

Concerning the design of the pension scheme as well as the major objectives concerning income distribution see Schmähl (1999), paragraph 4.3.

Beside the change in the pension adjustment formula, also the formula for calculating the transfer from the general public budget to social insurance was changed, aiming at a more or less constant ratio of public transfers to pension expenditure of about 20 %. This tax-financed transfers were for covering those expenditure, that were not (adequately) based on former contributions, but are aiming at interpersonal redistribution. There was always a debate on the adequate sum of money from the *public budget* to the pension scheme. Additional decisions - which will be mentioned later - were in the meantime taken to increase the percentage which in the public debate is now looked upon as being sufficiently high for this purpose.

The 1992 Reform Act was also aiming at postponing retirement. After a long controversial discussion it was decided that beginning in the year 2001, over a period of more than 10 years some deductions from the pension should be introduced step by step, if retiring before age 65. Age 62 should become the earliest retirement age for starting an old-age pension, equal for

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<sup>7</sup> Retirement at age 63 became possible, if 35 years of insurance had been fulfilled.

<sup>8</sup> Later also for handicapped a further lowering of the retirement age was decided, see Jacobs and Schmähl (1989).

men and women. The deductions were decided to be 3.6 % (below an actuarial fair rate) per year of earlier retirement.<sup>9</sup> Disability pensions, however, should not be burdened by a deduction.<sup>10</sup>

A political objective concerning the level of pensions compared to earnings was decided upon in the 1992 Reform Act: For a so-called standard pension with 45 Earnings Points (e.g. an "average earner" with 45 years of insurance) the pension shall be about 70 % of present average net earnings of all employees.<sup>11</sup> Because pension adjustment rates were linked to the increase of average net earnings, the individual net pension level (individual net pension compared to average net earnings) remains constant over time.

It is important to note, that the 1992 Pension Reform Act was based on a broad political consensus among the governing coalition parties and the major opposition party in the German Parliament and among employers' organizations and trade unions.<sup>12</sup> This consensus was in line with the experience from former major changes in pension policy in Germany. The search for solutions on a broad political basis in this area, that needs a long-term perspective, could be interpreted as being an element of the "political culture" in Germany. Contrary to some other countries, the biggest political parties (Christian Democrats and Social Democrats) both were in favour of the "social state"<sup>13</sup> and shared many basic values.

I mention this fact because, as will be outlined below, this consensus has broken. But at the end of 1999 there was a new approach to find a consensus between political parties on important matters of pension reform. I will come to this at the end of the paper.

For many years, a broad consensus among employers, trade unions and government also existed in aiming at a reduction of unemployment by early exit of older workers from the labour force as a socially accepted measure, because it would give younger people a better chance to become employed. This consensus broke down: Since summer 1995 a political discussion was going on aiming at a reduction of early exit and the costs linked to this especially for unemployment insurance and social pension insurance, although

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<sup>9</sup> Another new element was the introduction of a partial pension. Mainly because of the unfavourable labour market conditions as well as of other possibilities to leave the labour force early, this possibility for a phased retirement up to now has been no success. Only a negligible number of pensioners claimed such a partial pension. It is possible to claim either one third, one half or two thirds of the pension and supplement earnings from part-time employment. - Viebrok (1997) analyses in a very differentiated manner the labour supply effects of the German social security scheme, theoretically (taking into account the institutional arrangements) as well as simulating effects based on a dynamic programming approach.

<sup>10</sup> The changes of the adjustment procedure as well as the new formula for federal grants are elements of a self-regulating mechanism for the pension insurance scheme. For a more detailed analysis see Schmähl (1993a).

<sup>11</sup> For employees with lower pension claims this percentage is lower and vice versa. E.g. for a pension based on 40 EP the target pension level is  $40/45 * 0.7 (= 62.2 \%)$  instead of 70 %.

<sup>12</sup> The "social partners" - unions and employers' organizations - also work together in the self-administration bodies of social insurance.

<sup>13</sup> The term "social state" (Sozialstaat) is used in Germany instead of "welfare state"; Wohlfahrtsstaat is the German literal translation. Wohlfahrtsstaat has in German a different meaning compared to "Sozialstaat".

unemployment remained on a high level.<sup>14</sup> Especially the effect on contribution rates and therefore also on non-wage labour costs was accused to be a negative factor in times of intensified international economic competition.

In February 1996, the Federal government decided upon measures aiming at stopping the growing number of early retirees claiming an old-age pension at age 60 after a phase of unemployment: (1) The phase-in of the deductions from the full pension (3.6 % per year) started already in 1997 (and not in 2001) and will be much quicker compared to the rules in the 1992 Act: For pensions after periods of unemployment (age 60) the reference retirement age was to be increased within 3 years (up to the end of 1999) by 3 years; thereafter for all types of old-age pensions<sup>15</sup> within the following 2 years up to 65. For the specific female retirement age (at 60) this process will (after strong resistance by several organizations) start in 2000 and the reference retirement age will be 65 at the end of 2004.<sup>16</sup> - This measures were not anymore based on a political consensus.

For claiming a pension at age 60 beside unemployment an additional possibility was created: "part-time employment" of older workers after age 55, which - under special conditions - is supplemented by benefits from unemployment insurance. However, there is a lack of part-time jobs, especially for men.<sup>17</sup> Therefore, in reality this "part-time" employment means for half of the period full employment, thereafter employment with working hour of zero.<sup>18</sup>

In the following paragraphs the development and debates since 1997 shall be outlined, because they are an important basis for the present discussions and are in part disputed up to now.<sup>19</sup>

#### **4 The 1997 reform measures (the '1999 Pension Reform Act')**

In summer 1996 because of a growing public debate on issues of pension policy (reasons are outlined in Schmähl 1999) the Federal government appointed an expert commission (chaired by the Minister of Labour) to propose additional measures for a new pension reform to be realized at the end of 1997 at the latest, i.e. near the end of the election period (the next parliamentary election was scheduled for September 1998). There were also commissions by political parties, especially by the governing Christian Democrats. Ideas of the expert commission were discussed more or less in a parallel way in the party commission.

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<sup>14</sup> A widely used measure for pre-retirement was and is the layoff of older workers and supplementing the unemployment benefit by a payment of the employer, so that the net income of the now unemployed person remains nearly the same as in the period of employment. After a period of unemployment, the old-age pension can be claimed at age 60. There was a sharp increase in taking up this type of pension. In 1994 about 20 % of all male pensioners claiming a pension used this pathway into old-age pension; in East Germany this percentage was even much higher, more than 40 %. This measure was used particularly by big companies.

<sup>15</sup> This means that also the existing "flexible" pension, which can be claimed from age 63, will be "burdened" by deductions.

<sup>16</sup> According to the 1996 decisions old-age pension could be claimed at the earliest at age 60, however with a deduction from the full pension by 18 % (5 \* 3.6 %).

<sup>17</sup> This is also the main reason, why the "partial pension" introduced already in 1992 has not become an effective instrument. E.g. in 1994 only 0.15 % of all new pensions were partial pensions.

<sup>18</sup> For a detailed discussion of early retirement see Gatter and Schmähl (1996).

<sup>19</sup> The following two paragraphs are mostly based on Schmähl (1999).

While the government had a majority in the "Bundestag" (the federal parliament), the second chamber, the "Bundesrat" (representing the states, the "Länder") was and still is dominated by the Social Democratic Party.<sup>20</sup>

The debate in the commissions and the public debate concentrated on two main areas:

- Possibilities for a further reduction in the development of pension expenditure, aiming above all at a reduction of financing burden for "future generations" and
- a "fair" distribution of "burden" in financing of current pension expenditure, taking into consideration the different distributional targets (intertemporal versus interpersonal redistribution), and especially aiming at a reduction of non-wage labour costs because of labour market reasons.

The proposals of the expert commission aimed at maintaining the concept of earnings- and contribution-based (defined-benefit) pension scheme, while the concept of tax-financed flat-rate pensions was rejected. This was also backed by the majority in the political decision process. The main instruments to realize the above mentioned goals - as in principle proposed by the commissions<sup>21</sup> and finally politically decided - were the following:

In addition to already introduced changes in *retirement ages* for old-age pensions, deductions from the full pension were decided also for *disability* pensions. This was linked to some changes for old-age pensions oncemore: Starting in 2012, the earliest age to claim an old-age pension should be 62, but only for those having 35 years of insurance. The deductions would be  $3 * 3.6\%$  from the full pension. These 10.8 % should also become effective for disability pensions in general.<sup>22</sup>

Additional pension expenditure, however, result from higher *crediting years for child care* - a measure that in general is an element of family policy (and resulting in interpersonal redistribution that should be financed from general public revenue and not from earnings-based contribution payments; this will be discussed below).

The most important change concerning expenditure was the decision to introduce a so-called "*demographic factor*" as an element of the formula for calculating and adjusting (all) pensions. The main argument was the following: Life expectancy increases; if the contribution rate is not to increase in spite of this development, a reduction in the pension level has to take place. The solution proposed by the majority of the expert commission of the government - and later decided by the federal parliament - was a compromise:

The pension adjustment rate should be linked beside the rate of change of average net earnings<sup>23</sup> also by one half of the development of (further) life expectancy of people aged 65,

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<sup>20</sup> It is not possible to go here into the process of passing a law. But if the states are affected, they have to approve it, too. Even in all other cases a complicated, time-consuming process is necessary if there are different majorities in parliament and Bundesrat.

<sup>21</sup> See especially the proposals of the Expert Commission (1997).

<sup>22</sup> There are some other technical changes not discussed here as well as changes for pensions for handicapped people.

<sup>23</sup> Which reflects also increases in life exptectancy as far as this increases the contribution rate of the pension scheme.

however, with a time lag of 8 years. The parameters of this formula were chosen in such a way, that - in combination with other assumptions determining the financing of the pension scheme - the so-called standard pension level (a pension based on 45 Earnings Points and compared to average net earnings) up to the year 2030 should be reduced from 70 % to 64 %.<sup>24</sup> How quick such a reduction of the standard pension level could take place according to this formula depends in reality, however, among other factors on the development of life expectancy.

The parliamentary decision to include such a factor - aiming at a reduction in the pension level - could have, at least in the long run, some very negative effects. Some arguments to explain this opinion are the following:

- (1) Transparency of the pension formula is reduced, it becomes less understandable for the insured.<sup>25</sup> This may lower the acceptance of the scheme.
- (2) The introduction of the additional factor is a (first) step to break the link of pension development and earnings development. This earnings-linked pension development has been a corner-stone of the German public pension scheme since 1957 (and it exists in principle also in the specific pension scheme for civil servants).
- (3) The pension level becomes a variable; a specific number of Earnings Points does not anymore give the insured person an information about the relative amount of the pension compared to average net earnings. Planning for own additional old-age provision becomes more complicated.
- (4) The reduction in the pension level has remarkable consequences for the income of the insured and
- (5) the general reduction of the pension level can have the effect that a great number of employees even after long periods of paying contributions to the scheme only receive a pension that is hardly higher than social assistance. This could undermine legitimacy and acceptance of the mandatory contributory scheme.

The last two points shall be illustrated by some numerical information: Based on the rules for calculating and adjusting pensions as decided in 1989 and explained above, the "standard pension" (45 EP) is about 70 % of average net earnings (of all employees). Compared to this a full claim for social assistance (if no other income exists) is 40 % of average net earnings. A contributor who was an "average earner" needs 26 years of insurance to receive a pension just as high as this social assistance level. Somebody who only earned 2/3 of average earnings even needs 40 insurance years. If the pension level is reduced generally as aimed at by the additional factor in the pension formula, more years of insurance are needed for a pension that is as high or even above the social assistance level.

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<sup>24</sup> If a pensioner has 40 EP instead of 45 EP (standard pension) the present pension level is  $40/45 * 0.7 = 0.62$  and would decrease according to these plans to  $40/45 * 0.64 = 0.53$  for the full pension when claiming the pension at reference retirement age (i.e. in the future at age 65).

<sup>25</sup> In my view it would be preferable not to make pension insurance directly dependent on the development of other variables (like the different contribution rates to social insurance and income tax), but on the contrary to limit the number of these variables: Linking the pension adjustment rate only to the growth rate of average gross earnings and the contribution rate to pension insurance. This is discussed in Schmähl (1997).

Therefore, for the future it is decisive how many Earnings Points workers can accumulate during their working life. Here one has to take into consideration the following facts: (a) Today about 50 % of male and 95 % of female old-age pensioners have less than 45 EP. (b) Future working lives (and earnings development) may be less stable than in the past. This may reduce the possibility to accumulate pension claims (EPs). (c) There are already changes in rules for pension calculation that do not affect the (fictitious) standard pension (which always is based on 45 EP) but the individual EPs (an example is the reduction in years credited for schooling). (d) In the future a "full" pension without deductions will be paid at age 65. Those who retire earlier (e.g. at age 62) have a reduction of 10.8 % in their pension amount.

Assuming a standard pension level of 64 % (45 EP at age 65), when claiming the pension already at age 62, even the standard pensioner has a pension level of only 57.1 % (of average net earnings). If a pensioner has 40 (instead of 45) EP, his pension level is less than 51 % (while the social assistance level is 40 %).

In the long run, such a development could undermine the legitimacy of a scheme obliging employees to pay (high) contributions for a long time without giving pensions that are remarkably higher than social assistance.

An alternative, namely increasing in the future the retirement age to cope with the consequences of an increasing life expectancy, was rejected as not politically feasible in case of high unemployment and especially because only future (new) retirees would be burdened, but not present pensioners.

By its majority in the Bundestag, government in 1997 could realize changes which affected the expenditure side of the social insurance budget. The opposition parties were strongly against the changes for disability pensions as well as the new factor introduced into the pension formula. They promised that these reform measures would be cancelled if a change in government took place after the 1998 elections.

To avoid higher contribution rates in the pension scheme and even to reduce the contribution rate and thereby (non-wage) labour costs, government planned to give more money from the federal budget to the pension scheme to cover some of those expenditure aiming at (interpersonal) redistribution, but still financed by contribution revenue. An increase of the value added tax required the agreement of the second chamber, the Bundesrat, with its majority of the opposition party.<sup>26</sup> Although all political parties wanted such a change in the structure of financing (as well as employers' organizations and trade unions)<sup>27</sup>, only after a process of many months the opposition agreed in increasing the value added tax.<sup>28</sup> The revenue of one percentage point of value added tax is now given as additional federal grant to the pension scheme.

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<sup>26</sup> Revenue of the value added tax is for the state as well as for the federal level.

<sup>27</sup> A detailed discussion of the financing structure, its effects and the arguments for change is given in Schmähl (1998).

<sup>28</sup> The reason why they agreed, mainly was the fact that due to the unfavourable labour market situation (especially a downward development in the number of contributors and a slowdown of contribution revenue) the contribution rate in 1998 otherwise would have had to be increased from 20.3 % to 21 %.

## **5 Decisions in pension policy after the election to the German Federal Parliament in September 1998 up to the end of 1999**

The coalition government of Christian Democratic and Liberal Party was replaced after the September election to the Bundestag in 1998 by a coalition of the Social Democratic and the Green Party. As announced and proposed by Social Democrats prior to the election, they wanted to abolish some of the measures the old coalition had decided. However, the Green Party is in principle in favour of a general reduction of the pension level in combination with more redistribution within the scheme. The Green Party's arguments are especially focused on the "younger generations", lowering their contribution "burden" and giving them more chances for private capital funded pension claims. Therefore, the new coalition only agreed upon a suspension of two major elements of the '1999 Pension Reform Act' namely the so-called "demographic factor" of the pension formula and new rules for disability pensions: Up to the end of the year 2000 decisions shall be taken to replace these elements; if government is not successful in doing so, the old rules shall be implemented.

Some decisions were taken very quickly, namely to increase the transfers from the federal budget to cover expenditure for redistributive measures within the pension insurance, resulting from German unification as well as from crediting Earnings Points for child care. For the latter, contributions will be paid in the future by the federal budget to pension insurance to cover these pension claims. This is in line with already existing rules. E.g. for periods of unemployment, the unemployment insurance pays contributions to the pension scheme as well as to the new long-term care insurance for caregivers (see Schmähl and Rothgang (1996)). This is - from my point of view - an approach, which results in a clear rule step by step: Pension claims are only granted, if an adequate contribution payment is existing (from gainful employment or from other public budgets which are responsible for the specific task). This will make the contribution-benefit link in social pension insurance even closer as it is today and may increase acceptance for the scheme.

These additional payments from the federal budget made it possible to reduce the contribution rate from 20.3 % (in 1998) to 19.5 % (in April 1999). The money is to come from an energy tax (on gasoline and electricity). This becomes the third source of transfers from the general public budget to pension insurance beside the general federal grant from general revenue, and the additional federal grant from the revenue of 1 percentage point of the VAT.

Additional decisions are aiming at increasing the number of contributors to the pension scheme, namely new types of self-employed as well as employees with earnings below a lower contribution limit. The existence of such a limit (about 1/7 of average gross earnings) without paying contributions gives an incentive for employers to offer such jobs as well as for employees to accept them (even in addition to another job which is covered by social insurance).<sup>29</sup>

The new government, like the old one, tries to reduce contribution rates which are based on labour income. Especially a reduction of labour costs is an important objective. Reduction in

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<sup>29</sup> If for social pension insurance the contribution-benefit link is very close, then the attractiveness of not being covered will be reduced as well as the "tax wedge" - compared to the difference of labour costs and net earnings of employees (for a detailed discussion see Schmähl 1998).

income tax that the new government decided upon, would have an increase in pension adjustment rates because of the link of pension adjustment to the development of (average) net earnings of employees. This increase of expenditure would, however, increase financing issues. Therefore, the government decided to increase pensions for two years (2000 and 2001) only according to increase of price index and not according to average net earnings. Government announced, however, to adjust pensions in the years to come in line with increase of net earnings. There are some doubts, whether this will really take place.

Among the reasons for such doubts is a decision from the Constitutional Court, which is now expected to be taken in the year 2000 on the taxation of social insurance pensions compared to taxation of pensions for civil servants. If an increase in income tax burden of social insurance pensioners would become necessary, then there are problems with the practice of pension adjustment according to net earnings of employees (which are burdened by income tax). In addition, the German pension adjustment formula has become very complex and complicated. Therefore proposals exist for a more simple pension formula. This is, among other things, brought into the discussion by a report of the Social Advisory Council of the Federal Government. According to this proposal only the development of average gross earnings and the contribution rate to pension insurance should be taken into account. Pensioners themselves have to pay an individual contribution to health insurance as well as long-term care insurance.

But there are other proposals to integrate some indicators of demographic development into the pension formula. This will be one of the topics for further discussion. At the end of 1999 coalition government (of Social Democrats and the Green party) agreed with the opposition parties CDU and FDP (Liberal Party) to try to find a consensus again in pension policy. In the first quarter of 2000 there shall be the first meeting based on some proposals of a working group of the parties established in December 1999.

On the agenda there will be some other topics. Some of them are already well known, because in June 1999 government published some "corner-stones" of a pension reform, government is aiming at. The main topics are

- introducing a tax financed and means tested minimum pension into social insurance instead of relying on means tested social assistance in case of income too low to finance one's living. This is opposed very much. And if there really will be a consensus between the parties, this proposals will not be implemented. However, there are proposals to look for a "third way" - outside social insurance, but also not being social assistance.
- Improving supplementary capital funded pension protection. Minister Walter Riester originally had in mind a mandatory coverage. There was resistance by his own party. But meanwhile there are several actors more or less pronouncedly supporting this idea. The opposition parties are in principle for voluntary supplementary coverage. All are in favour of tax-financed incentives. Whether there will be incentives in addition to already existing incentives or whether they will be more focused on old-age security is not clear. But taking the limitations of tax financing into account one can expect, that there will be a shift in tax financed incentives more into the field of old age security.

Government would like to link additional supplementary provision to social insurance: Additional supplementary provision is to be looked upon like contribution or tax payments and should reduce the increase of net earnings. This will reduce pension adjustment and

pension expenditure. However, a further reduction in the pension level may cause some more problems in legitimizing mandatory contribution payments if the level of pension claims which can be accumulated by contribution payments is not really higher than social assistance even after many years of contributing.

In Table 3 some data are given for the development of the contribution rate in the German social pension insurance based on a bundle of assumptions which cannot be outlined here in detail. They are based on the official projections of the German Federal government, which are for the next 15 years. The model projections are published by the Social Advisory Council of the German Government (which the author is chairing) up to the year 2000. In Table 3 only data for 2 years - 2020 and 2030 - are included.<sup>30</sup> The figures also show the effect of the introduction of a mandatory additional contribution for old age (invested on private capital market), starting with 0.5 % of gross earnings in 2003 and increased in steps of 0.5 percentage points up to 2.5 % in 2007 (thereafter remaining constant). This would reduce the contribution rate in social insurance by about 0.7 percentage points if the additional contribution reduces the development of net earnings and therefore also pension adjustment rates in the years of introducing the additional contribution. There are strong cohort-specific effects linked to this proposals (because for example pensioners receive lower pensions but will have an additional capital-funded pension). This cannot be outlined in detail here but shows that many aspects of income distribution have to be taken into account.

There will also be a debate on additional measures in favour of families with children and concerning old-age protection of women and the role of widow(er)'s pensions. These pensions are depending not only on the pension of the deceased spouse, but also on own pension claims and own labour income of the widow(er). It can be expected that the rules for calculating these pensions will be modified, e.g. by taking into account more types of income. But all proposals in this area are up to now relatively vague.

At present there is also a discussion on compensating the deductions from the full pension in case of early retirement. Some trade unions are pushing this idea, but the employers are against it. For the future, however, the topic of retirement age needs to be put on the political agenda, however, aiming in the opposite direction: increase of retirement ages mainly as an instrument to cope with the problems of an ageing population.

My personal proposal is that reference retirement age (age for receiving the full pension, without deductions) could be linked to changes in life expectancy, while the pension formula itself remains constant (proposed in Schmähl 1997a). Such an increase in retirement ages could start e.g. around 2010/2015, in a period when labour market projections show a change in labour market conditions, among other things because of the demographic development (resulting in a remarkable reduction in labour supply). This would show workers very clearly that they have to make a decision: Working longer and having the same pension level as today for about the same length of retirement or receiving the pension for a longer time, but at a reduced level (because of the deductions from the full pension). It is an open question, whether this topic will be taken up in the "consensus talks" of the political parties in the year 2000.

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<sup>30</sup> The data for all years from 2000 to 2030 are published in the 1999 report of the council (however only available in German), Sozialbeirat (1999).

Taking into account that the modification of the pension formula of the former government is only suspended for two years (in which now only adjustment according to price index development will exist), it should be decided at least at the end of the year 2000 what the alternative shall be in the future. The topic of pension (adjustment) formula has to be linked to other decisions in designing future pension policy in social insurance as well as in private insurance (supplementary pensions, mandatory or voluntary, with tax incentives, for which types of old-age protection instruments etc.). The Ministry of Finance will therefore be an important actor in this field. But also commercial banks and insurance companies are very active to get a bigger slice of the growing "pension cake". And, of course, trade unions and organizations of employers and from industry have own proposals and aims.

At the end of the year 1999, when this report was written, there is some optimism in official statements of political parties as well as of the government that a consensus will be possible. What the real contents of this consensus - if it comes - will be, is not quite clear, because the effects are very much depending on the exact definition of measures. They will show, what road for pension policy in Germany will be taken in the next future.<sup>31</sup>

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<sup>31</sup> Concluding remark: The author was member of the Enquete-Commission of the Federal Parliament, the Expert-Commission of the Federal government as well is chairman of the Social Advisory Council of the Federal government on pension policy (reports are mentioned in this paper). The interpretation as well as the evaluation, however, is only the personal view of the author and should not be identified with opinion of other members.

**Table 3: Contribution Rates and Pension with and without a "Supplementary Contribution"**

year	contribution rate social insurance		total contribution rate incl. supplementary contribution (***)	standard pension (net) *) (social insurance)		supplementary pension at year of retirement (**)		sum of standard pension (net)*) and suppl. pension	
	without supplementary contribution	with supplementary contribution		without supplementary contribution	with supplementary contribution	interest rate for supplementary contribution		interest rate for supplementary contribution	
						4%	5,5%	4%	5,5%
	%		%	in DM / month		in DM / month		in DM / month	
	1	2	3	4	5	6	7	8 (=5+6)	9 (=5+7)
2020	20,6	20,0	22,5	3525	3425	161	204	3586	3629
2030	23,9	23,2	25,7	4628	4497	369	494	4866	4991

\*) net = pension after deduction of pensioner's contribution to health insurance and long-term care insurance

\*\*\*) average earner with supplementary contribution since 2003, pension for 18 years (insured person); 10 years (widow/er)

\*\*\*\*) 10% are deducted from supplementary contribution as administration costs

Source: Taken from Social Advisory Council (1999); calculation of supplementary contribution by Ministry of Labour and Social Affairs.

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