A PENSION SYSTEM IN TRANSITION:

PRIVATE PENSIONS AS PARTIAL SUBSTITUTE TO PUBLIC PENSIONS IN GERMANY? *

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Winfried Schmaehl, Centre of Social Policy Research, Bremen

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Abstract

This paper discusses a new strategy in German pension policy implemented in 2001 and looks at the main instruments and effects. The reform measures are based on a paradigm shift in pension policy, which will change the structure of the German pension scheme. Partial substitution of public pensions by subsidized private and occupational pensions is a core element. The paper outlines the structure of the pension scheme prior to the reform measures and the main objectives for the existing rules. Major arguments framing the public pension debate in Germany and important actors in the pension arena are identified. The instruments for reducing public pension expenditure (especially a new formula for adjusting benefits) as well as the subsidies to stimulate private and occupational pension arrangements are discussed. Employees are now confronted with complex and complicated decisions because of a great variety of possibilities of saving in subsidized forms. There is some doubt whether this will increase saving. The paper also focuses on a number of questions regarding income distribution related to the new strategy of partial substitution of public by private pensions as well as on the future development of the German pension scheme and on conflicts that may result from this strategy.

1. The public-private divide in Germany's pension debates – some introductory remarks

For some years the public-private divide in pensions in Germany has been closely linked to the different financing methods such as capital funding and pay-as-you-go (PAYGO). This was not always the case. On the contrary, since the introduction of the social statutory pension insurance in Germany in 1889, up to the year 1956 this branch of social insurance was – according to official statements – based on capital funding – although several economic and political shocks made it necessary to run the scheme on a PAYGO basis for longer periods and prevented the accumulation of reserve funds from gaining an amount sufficient according to actuarial calculations. The level of public pensions remained low. During all these years occupational (firm-based) arrangements (whether lump-sum payments or pensions) as well as additional private saving for old age were always a supplement to social insurance pensions.

During the Nazi period, accumulated funds of the public pension scheme were used for financing public expenditure including military purposes. Funds were nearly totally lost after the collapse of the Nazi regime. Nevertheless, despite these experiences the accumulation of funds within the social pension insurance scheme started again after the Second World War. This money was especially used for financing investment in housing. But in contrast to this development and to dominating views in ministries as well as in the pension administration, economic arguments in favour of PAYGO financing of the public mandatory pension scheme gained political influence in the 1950s.[1] However, the shift from capital funding of the public scheme towards PAYGO was not yet fully realized in the great pension reform of 1957, but the reserve requirement of the public scheme was reduced as far as necessary to cover expenditure of one year at the end of a ten years calculation period. In 1969, the reserve requirement was again reduced to cover expenditure of three months, later on to only one month and in 2002 to 0.8 months.

Although there have been several proposals for accumulating funds within the public scheme during the last decades as a means to “tunnel“ the emerging “pension mountain“ (i.e. to increase contributions above the level that would be necessary to balance the budget and to use the funds later in order to prevent a rapid increase in the contribution rate) the currently dominating opinion in Germany is that capital funding should only be realized in the private sector. One important argument is that accumulated reserves within the public sector are an incentive to increase expenditure. It is not surprising that actors in the financial market are much in favour of such a separation of capital funding (private) from PAYGO financing (public). Therefore, talking about the public-private divide in Germany also means the relative weight of funding compared to PAYGO financing.

The already mentioned 1957 pension reform led to an important change in public pension policy. By inserting dynamic elements into the social insurance pension scheme, the pension level was linked to the growth rate of average gross wages and pensions were increased by about 70 per cent on average within one year. It was one major objective of the 1957 reform that pensions should replace earnings according to former (relative) wages during the working career and hence should not only be regarded as an instrument to avoid poverty in old age. Pensioners should also be able to participate in the “fruits“ of economic development. This paradigm shift resulted in an increase in public pension expenditure as a percentage of GNP from 4.2 per cent in 1956 to 5.6 per cent in 1957. There was a strong resistance by the Federal Reserve Bank (Bundesbank) as well as by employers and other industrial organizations arguing that this would push up the inflation rate and undermine the ability and willingness to save for old age. These fears proved to be wrong. The remarkable increase in social insurance pensions did not result in inflation and did not crowd out occupational or individual private old-age provision. There was no negative effect on private saving.

It has been well known in Germany for many decades that the age-structure of the population is going to change and to become a challenge for pension policy and other areas of social and economic life as well. Population ageing has been labelled as an economic "burden". The fact that social insurance contributions are shared between employees and employers[2] results in rising non-wage labour costs if the contribution rate increases.[3] Not surprisingly, employers and their organizations call for a reduction and not for an increase in contribution rates. This became a powerful political argument in Germany especially because of growing labour market problems. There are several ways to reduce the contribution rates. One was particularly common in the 1990s where revenues from the federal budget were increased in order to cover the pension expenditure in social insurance that aims at an interpersonal redistribution of income. This – as well as a reduction of such expenditure – strengthened the contribution-benefit link within the German pension insurance scheme.

This development was in contrast to a transformation of the public pension scheme from an earnings-related scheme (based for the most part on the idea of equivalence and reciprocity) to a flat-rate pension scheme (based on the idea of citizenship) as it was sometimes suggested in Germany. The role of the state as a provider of pensions was intended to become smaller and private (capital funded) provision should increase by such a (PAYGO financed) flat-rate pension. But such proposals – published during the last decades by the Liberal Party (FDP), the Green Party as well as by some members of the Christian-Democratic Party[4] – never gained much political support.[5] The most recent proposals for changing the public-private mix in pensions and financing did not focus on the contradiction of 'earnings-related' vs. 'flat-rate', although this topic may again become relevant in the future. This depends very much on the strategies and means for realizing a shift in the public-private mix of pension provision. This is discussed below.

There are several political and economic reasons for a new public-private divide in German pension policy. One is the change in normative positions related to the role of the state. Since economists changed their proposals regarding the approach in economic policy from Keynesian macroeconomic demand-oriented policy to a supply-oriented neoclassical microeconomic policy, public expenditure and its financing was more and more considered as a hindrance to market forces. The process of German unification required an increase in public expenditure, including social expenditure. The high ratio of public expenditure as well as public debt is often criticized. The Maastricht criteria also result in political pressure to reduce public expenditure.

From a political point of view it seems to be attractive to shift expenditure from public to private households because many citizens do not fully recognize that additional private saving or private expenditure are needed if public expenditure is to be reduced, in this case regarding the provision for old age. Such a shift will reduce the burden of the public budget but not necessarily the burden for the private household – sometimes on the contrary, as will be discussed below. There are many actors interested in channelling pension money via capital markets, promising higher efficiency in case of private instead of public activities and higher rates of return. This opinion seemed to be very realistic and attractive in the light of the development on the stock market.

The public debate was framed by the argument that demographic changes will bring about a "pensions crisis": The burden in the public pension insurance will become unbearable – especially for the younger generation. "Generational equity" thus became an important and powerful catchword in the public debate. The widely believed conclusion was that public pensions cannot remain at the present level, they have to be reduced and they will no longer be sufficient to maintain the "standard of living" in old age in the future. Only a shift from public to private pensions will not overburden younger generations. These opinions prepared the ground for a pension reform that was finally decided on in 2001 in its major parts. [6] These reform measures are important for a new public-private mix in pensions that is emerging now in Germany. These pension reform measures are based on a paradigm shift in pension policy.

This is much in line with the mainstream of the international pension debate arguing for a new mix of public and private pension provision and linked to this also a new mix of financing methods.

This paper deals with these new developments in Germany. First, a brief outline of the institutional structure of Germany's system of old-age protection is given (section 2). Then the framing of the recent pension debate in Germany is illustrated (section 3) Major elements and some of the effects of the 2001 pension reform are discussed (section 4). The focus is on changes in normative positions and their effect on the design of the pension schemes. This will be illustrated by comparing the new rules to those existing before the 2001 reform. Effects on the benefit level as well as on financing by the new measures are highlighted as well as new rules for private and occupational pension arrangements. Finally (section 5), some reflections concerning the future development and economic effects are made. There are few empirical results regarding effects because the new rules have only been implemented since the beginning of 2002. Nevertheless, some effects seem to be obvious and some others likely if the present strategy in pension reform remains effective in the future.

2. The institutional structure of Germany's pension schemes and some major distributional objectives

2.1 The institutional structure until the 2001 pension reform

As in most industrialized countries, in Germany formal pension arrangements[7] have been based on different tiers for a long time. These tiers include:

– mandatory basic schemes (first tier),
– supplementary occupational schemes (second tier) and
– additional private old-age provision (third tier).

The German pension scheme has public and private as well as mandatory and voluntary elements. They are often linked to tax incentives. Many of the existing features of the German pension schemes can only be explained historically. The basic first tier of the German pension system is not a single scheme covering all citizens but consists of several elements: The core element of the first tier as well as of the whole pension system in Germany is the statutory (social) pension insurance, covering all white- and blue-collar workers and some groups of self-employed; see Overview 1 (section framed by the bold line). Quantitatively it is by far the most important pension scheme in Germany regarding coverage as well as expenditure. Therefore, political debates as well as public attention are primarily focused on the scope and design of this scheme.

Social pension insurance consists mainly of three branches: for blue-collar workers, for white-collar workers and for miners. Pension calculation and financing are identical for the first two branches. There are fiscal equalization rules between the two branches and for miners there are some additional rules: The level of pensions is a combination of first and second tier elements and contribution rates are higher. Pension benefits in social pension insurance are granted in case of old age, disability and for survivors.[8] The financing of pensions is on a PAYGO basis by contribution payments of employees and employers from gross earnings up to a ceiling (of about 180 per cent of average earnings) and by general tax revenue covering about 20 % of pension expenditure for blue and white collar workers but about 70 % for miners.

The calculation of social insurance pensions is based on the relative gross earnings (i.e. individual gross earnings compared to average gross earnings of all employees) for all years of the contributor's earning career. Pension claims are accumulated in individual accounts. It is a defined benefit pension scheme. The pension formula and its normative background as it existed at the end of the nineties will be discussed below as well as the changes that are linked to the new pension reform measures.

– Overview 1 –

Beside social insurance there are several special pension schemes as first tier for specific groups of the population. For civil servants pensions are linked to individual last gross earnings (final pay scheme). The percentage of last (gross) earnings (at a maximum of 75 per cent) depends on the number of years of service. These pensions can be regarded as a combination of first and second tier, an integrated scheme of a basic and an occupational element. Financing is on a PAYGO basis from general tax revenue of the public budgets on the federal, the state and local level.

The special scheme for farmers is – like the scheme for miners – mainly financed by general tax revenue. Contributions by farmers as well as pension calculation differ from social insurance. Farmer's pensions are an addition to income from farming or assets (farm ownership).

The pension schemes for members of professional associations – like doctors, lawyers, architects, tax consultants, pharmacists – are capital funded and differ in many respects between the schemes.

About half of the self-employed are not mandatorily covered (Fachinger and Oelschlager, 2000, p. 165). Reliable empirical information on volume and type of saving for old age does not exist.

The second tier consists of supplementary occupational pension schemes in the private and public sector. In the public sector, in principle, all blue- and white-collar workers are covered based on collective agreements. These defined benefit schemes were integrated with social pension insurance realizing – as for civil servants – a certain percentage of last earnings as pension benefit, depending on years of service. A recent agreement abolished the linkage between last earnings and pension benefit (see below).

In the private sector voluntary schemes have dominated.[9] Coverage in the private sector is only about 50 per cent and very unequal according to branch and size of the firms and also for male and female employees depending on where they are employed. Occupational pension schemes were mostly of the defined benefit type.[10] There exists a great variety in designing occupational pension schemes. Financing was mainly by employers based on capital funding. There are also different organizational structures for such schemes within the firm as well as outsourced by legally independent organizations.

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

– Direct pension commitments made by the employer and financed within the firm based on book reserves. These are of special importance in Germany. Here the firm itself is the pension institution.[11] 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. Financing is by the employer, but the employee can also contribute.

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

– 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.[12]

Collective agreements on pensions in the private sector were exceptional up to the 2001 reform,[13] quite in contrast for example to the Netherlands. After the 2001 reform this is in a process of change. During the nineties a decline in occupational pension arrangements took place, by giving less favourable conditions to new employees or by closing schemes for newly hired employees. Coverage declined. Several reasons were mentioned for this development, among others, the costs of occupational pensions as part of labour costs. Employers see high labour costs as a severe disadvantage in periods of intensified international competition. In addition, firms specifically mention tax conditions as a reason for a downward trend in occupational pensions. It seems also that occupational pensions as an instrument of attracting qualified labour have lost their importance because of the labour market conditions (high unemployment).

It is important to note that taxation of pensions differs within the first and between first and second and within the second tier schemes. This has to be taken into account when comparing for example pensions of different schemes. The third tier consists of many different types of private saving and insurance for old age. It is difficult to give comprehensive statistical information on the amount of private saving for old age because saving (including life insurance) can be used for different purposes. Tax treatment also differs for different types of voluntary saving.

Overview 2 provides some information on the macroeconomic significance of pension expenditure in Germany in 1999 as well as of different institutions.[14] To simplify the picture one can say that about 80 per cent of all pension benefits are from the first tier, and 10 per cent each are from the second and the third tier. That also means cum grano salis that about 80 per cent of pensions are based on PAYGO and 20 per cent on capital funding. To change this ratio is one major objective of recent reform measures. It is obvious and not astonishing that several powerful actors are interested in changing the financing structure of old-age provision.

– Overview 2 –

Regarding income in old age, public transfer payments and especially social insurance pensions are by far the most important source for the majority of elderly people in Germany, in West Germany and even more so in East Germany (see Overview 3). This difference has historical reasons because in the former GDR in principle no occupational or private pensions existed as a source of income in old age (Schmähl 1991a). The introduction of funded elements for old-age security will take a long time before it becomes an effective instrument for financing one's living in old age. Income from assets (other than pension claims) is low on average in Germany.

– Overview 3 –

It has to be emphasized that living conditions in old age are not only dependent on income from pension schemes and from assets. A great number of other effects are relevant too. Beside intra-family transfer payments and sometimes income from work or self-employment, the conditions of health- and long-term care insurance as well as direct tax or own contribution payments to health and long-term care insurance are particularly important. If in health insurance for example co-payment is increased or health insurance does not cover specific expenditure then ill people have to spend more out of their income for these purposes. If people need long-term care and especially costly residential care, it is important whether benefits from mandatory long-term care insurance – introduced in 1995 – develop in line with costs for long-term care. If this is not the case – as in Germany at present – the frail elderly have to spend increasing amounts out of their income to cover costs. If own income and assets are not sufficient, social assistance payments are needed.[15]

The adequacy of pension benefits for financing one's living in old age is therefore influenced by the development of benefits in health and long-term care insurance as well as by contributions and taxes. In addition there are direct fiscal links between social pension insurance, health-, long-term care and unemployment insurance. Therefore, changes in other branches of the social security system can influence revenue and expenditure of the pension scheme as well as net pension benefits of pensioners. These interactions have to be taken into consideration when analyzing German pension schemes and their effects.

2.2 Two new elements in the German pension system after the 2001 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 (see Overview 1):

(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 amount 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[16] if their parents claim this new means-tested benefit in cases where their own income is not above 100,000 EUR per year.

(b) The second element is a subsidy for contributions for a private pension that has to fulfil certain restrictive 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.

These (as well as other) changes, which will be discussed below, are intended to cope with the challenges Germany's pension schemes are confronted with.

3. Framing the pension debate in Germany: Major challenges for pension schemes and arguments for change in pension policy

It is not new that pension schemes have to be adapted in response to changes in the environment in which these schemes are embedded. Changes in demography, the economic conditions, household structures but also in political objectives and normative positions are relevant as well as the effects of pension schemes themselves (for example incentives on the labour market). Up until the beginning of the 1990s there was a broad political consensus between the big political parties (Christian Democrats – CDU/CSU – and Social Democrats – SPD) regarding central elements of pension policy. This consensus unfortunately no longer exists.[17] At the centre of the debate in Germany as in many other countries are PAYGO financed schemes. Only a few remarks regarding the challenges for pension policy shall be made, illustrating the background for the reform debate in Germany. Many of the challenges are similar to many other countries, although the effects on pension schemes may vary according to scope and design of the national pension schemes.

It is well known that Germany is confronted with a pronounced demographic ageing, resulting from a low fertility rate (which is one third below the replacement level) and a rising life expectancy. The latter is a positive development, although in public debate it is usually labelled as a burden, a factor that results in additional costs for pensions, health- and long-term care insurance. As an indicator illustrating demographic ageing old-age dependency ratios (ADR) are often used as a starting point or even as a proxy for a system dependency ratio (pensioner ratio) which, however, is decisive for financing issues and is influenced by many factors besides demographics (Schmähl 1981, 1989, 1990). Overview 4 gives some results of the most recent official population projection. They show very clearly that ADR:

– depends on its definition (i.e. the beginning and ending of the working phase in the life cycle), which is largely related to conditions in a country,[18]

– is increasing over time,

– but is not changed fundamentally by migration (assuming realistic numbers of migrants),[19]

– can develop more smoothly over time if the beginning of the retirement phase is becoming later, an aspect that is taken up in the section dealing with "retirement ages"; compare for example the development of ADR (20/60)[20] and ADR (20/62) in 2030 or ADR (20/63) in 2040: The rate of increase would be much lower compared to an unchanged length of the phase of ability to be employed.

– Overview 4 –

Another important challenge results from economic conditions, especially from the high unemployment rate. This affects expenditure (early retirement) as well as revenue, both increasing the demand for additional financing by contribution revenue and/or federal grant. Difficult labour market conditions particularly in East Germany after unification are part of the problem. The different economic conditions in East and West Germany cause transfer payments from West to East Germany. This also holds in the case of social pension insurance. As a result, the contribution rate of pension insurance has increased by about one percentage point in both parts of Germany over recent years. It is expected that this will continue for many years to come.

Pension insurance was used for a long time as an instrument of labour market policy resulting in several pathways for early retirement without deductions from the full pension (Schmähl and Jacobs 1989, Schmähl 1992a and Schmähl et al. 1996). This policy was based on a broad consensus between government, trade unions and employers' organizations and influenced the expectations of employees regarding their retirement age as well as their behaviour. Firms widely made use of these possibilities for reducing and rejuvenating the work force. This increased the contribution rate. But high contribution rates –at present around 19 per cent[21] – are on the other hand attacked, especially by employers, as an element of high non-wage labour costs with negative impacts on economic competitiveness.[22]

The reduction of non-wage labour costs is high on the agenda of politicians, employers' and industry's' organizations.[23] Pension reform shall reduce the contribution rate compared to the development expected without reform measures. It was argued that this would improve the international competitiveness of German firms, as well as the take-home pay of employees, so that employees would have the possibility to save additionally for old age.

The demands of reducing public debt, reducing PAYGO schemes and their "implicit debt" and balancing the public budget were (and still are) often based on the vague concept of intergenerational equity. There is no political party that does not claim that their proposals are in favour of intergenerational equity or that the present PAYGO scheme is a violation against it. Intergenerational equity became one of the most widely used catchwords in German public debates. The different rates of return to be realized in public PAYGO and private capital funded pension schemes were often the main argument.

All these aspects and arguments – whether empirically well founded or not – were important in the public debate, a debate that was influenced very much by the mass media. The role of the mass media in framing the public pension debate in Germany increased substantially and up until now there has been a lack of research on this issue.

PAYGO pension schemes – namely social insurance, but also civil servants pension schemes[24] – were and are under severe political pressure. The major reform alternative for solving future problems in the PAYGO pension schemes was seen in a radical shift towards capital funding. While in Germany the introduction of funded elements into a public scheme in general is refused, proposals for more capital funding therefore are linked to proposals for privatising at least a part of old-age security. It is not surprising that the insurance industry, banks and investment funds were in favour of such reform strategies.

This pressure towards capital funding was not only focused on public PAYGO-financed social insurance but also on those parts of occupational pension schemes, which are based on book reserves. Two arguments 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 less efficient than the allocation of capital via capital markets.

Additional saving for old age in capital funded schemes instead of PAYGO financing was supported in the German (as in the international) debate by several economic arguments, which, however, often lacked a solid empirical base. Three lines of arguments in the German debate shall illustrate this.

(a) A shift towards private funded pension schemes will increase saving, improve investment financing and have positive effects on economic growth.[25] A comparison of countries with different volume and development of funded pensions – like the Netherlands and the United Kingdom in contrast to Germany – neither shows a higher total saving rate nor an increase of total saving rate during the process of increased capital funding. Substitution effects within different types of saving must not be neglected. And even if there would be additional saving there is no automatic process of increasing real capital formation and productivity.[26] Obviously economies "do not behave like well-oiled equilibrium machines" (Solow 1996, p. 301). This macroeconomic type of argument in favour of funding seems to have lost ground in recent years as a support of the idea for additional funding and a reduction of PAYGO. An argument more commonly put forward now in the German debate is described in (b) below.

(b) Funded schemes are superior to PAYGO schemes because of higher rates of return in periods of demographic ageing. However, this argument, too, has to be considered very carefully. While the rate of return in a PAYGO scheme is expected to decrease particularly due to a shrinking and ageing population, rates of return in funded schemes are assumed to be minimally affected by demographic development. Only recently, did actors in the financing industry mention the possibilities of negative effects of the ageing population on capital markets[27]. In the past this argument [28] had been strongly rejected.

Regarding rates of return there is often a lack of transparency and information on costs related to different products. In addition, rates of return differ remarkably regarding (1) type of investment, (2) the amount invested, (3) the historical period money was invested and annuitised or used for financing one's living in old age. Comparisons between PAYGO and funded schemes are also often biased in Germany because funded schemes are only for retirement pensions while statutory pension schemes also cover the risk of disability. The costs of private disability insurance are not negligible. A comparison should be based on risk adjusted net rates of return for identical contingencies. In addition transition costs for shifting from PAYGO to funded elements have to be taken into account.[29]

(c) In contrast to PAYGO schemes funded schemes – so the argument goes – have no negative incentives for the labour market. This assumes that they are privately managed, actuarially calculated funded schemes while the design of PAYGO schemes is also aiming at interpersonal redistribution. However, the German social insurance scheme has a relatively low degree of interpersonal redistribution, for example compared to the United States. And the contribution-benefit link can be made stronger in a PAYGO scheme. The PAYGO-financed "notional defined contribution schemes" as in Sweden and some other countries are an example but not the only way to strengthen the contribution-benefit link. In Germany several steps were taken to strengthen the contribution-benefit link:

(a) by redesigning benefits,

(b) by abolishing expenditure for pure interpersonal redistribution and

(3) by financing remaining interpersonal redistribution by general tax revenue instead of earnings-related contributions (Schmähl 1998c).

It also has to be taken into consideration whether interpersonal redistribution will be shifted to other schemes, for example if funded schemes are based on collective agreements or the state mandates funded schemes or regulates funded schemes in such a way that they have to take over interpersonal redistribution and become at least partially an instrument of public social policy. This can be seen in Germany in the highly regulated mandatory private long-term care insurance that is in part a substitute for mandatory public long-term care insurance.[30] In the past, for a short time the topic of mandating private pensions was on the political agenda with a proposal made by the present minister of labour, Walter Riester. Although the official statement of the government today is that there will be no mandatory second or third tier, the topic may become relevant again in the near future – as will be argued below.

The effects of demographic ageing on PAYGO financed social insurance was the central topic in public debate labelled as “demographic crisis“, a “time bomb“ which will shake the fundament of the German economy, resulting in a generational conflict if no radical change takes place.[31] These arguments were to prepare the ground for change. And this change was more or less only seen in a shift towards more private pensions, by substituting the “outdated“ PAYGO scheme to a large extent and establishing a “modern“ mix in financing methods. This was also the demand of many mainstream economists.[32] Reform measures within the PAYGO scheme were seen to be of minor importance. The debate was clearly framed towards this shift in the public-private mix. Several actors were working together towards realizing this: actors engaged in the financial market, the federal ministry of labour as well as of finance and the office of the chancellor, many economists and the majority of the media. The result was the 2001 reform package, the main elements of which will be outlined below. For a better understanding of these changes, they are compared to the design of the social insurance scheme, as it existed before as well as the underlying normative ideas.

4. The 2001 pension reform: a paradigm shift and a change in the public-private mix

4.1 Basic features and objectives of the social insurance pension prior to the 2001 reform

For a better understanding of the contents of the changes that have been introduced by the 2001 pension reform it is necessary to characterize the existing social pension insurance scheme. In 1957 an earnings-related dynamic 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.[33] The following elements of the social insurance pension scheme are important:

The pension insurance scheme 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 earns in a year just the average earnings, then he gets one Earnings Point. At retirement the sum of individual Earnings Points of all years of insurance is multiplied with a factor representing the value (in German marks, now in EUR) of one Earnings Point. This gives the pension benefit per month. This factor is the dynamic element in the German pension formula. In 1992 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 implemented in 1957. The rate of change of this factor is used for adjusting all pensions calculated in previous years. Therefore pensioners with the same sum of Earnings Points always receive an identical pension benefit per month (or per year) irrespective of the year of retirement.[34]

Regarding the distributional objectives underlying the German social insurance pension scheme several aspects should be highlighted: A dominating idea is income or consumption smoothing over the life cycle by implementing a relatively close relationship between contribution payment (respectively the earnings being the base for contribution payment) and pension benefits[35]. That means that inter-temporal redistribution over the life cycle is dominating the design of the scheme and not interpersonal redistribution. Interpersonal redistribution within the pension scheme is intended to be financed by general tax revenue (from the federal budget).[36] The German social insurance pension scheme differs from many public PAYGO financed pension schemes in other countries because of its relatively low degree of interpersonal income redistribution. There is a tendency now in many other countries (for example Sweden and Austria) to reduce interpersonal redistribution in order to realize a closer contribution-benefit link.

Within the social pension insurance, negative effects (among other things) of some risks like unemployment or illness (and an interruption of paying contributions to the pension insurance) on pension claims are in part avoided: Other social insurance branches pay contributions to pension insurance, as in the case of unemployment and illness. And from the federal budget contributions are paid to social pension insurance for those periods that are credited in case of caring for children.[37] Contribution rates and pension calculation are identical for men and women and this creates interpersonal ("intersexual") redistribution compared to a strong equivalence of contributions and benefits in voluntary private insurance.

It is important to note that in 1992 a clearly defined objective regarding the level of pensions was introduced: Individual pension benefits 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 for a so called “standard pensioner“ with 45 Earnings Points pension benefit should be around 70 per cent of net average earnings. For pensioners with respectively lower or higher numbers of Earnings Points the percentage is proportionally lower or higher. Because pension adjustment rates were linked to the increase of average net earnings, the individual pension level remains constant over time, so underlining that this is a defined benefit scheme.

4.2 Instruments used in the 2001 reform to reduce public expenditure and the development of the “necessary“ contribution rate

The preceding government of chancellor Kohl decided in 1997 to reduce the pension level[38] – this was much attacked by the opposition Social Democratic Party. The new rules did not become effective because of a change in government in autumn 1998. The new coalition government of Social Democrats and Green Party (chaired by chancellor Schröder) now themselves declared – as the previous government did – that without reform measures a “dramatic“ situation would exist in pension insurance around the year 2030. The central reason for this statement was the expected development of the contribution rate necessary to balance the budget of the social insurance scheme. Based on several economic and demographic assumptions the official projections showed an increase in the contribution rate from about 19 per cent at present to about 24 per cent in 2030. This contribution rate was declared to be much too high. Government decided on target contribution rates, until 2020 contribution rates should not exceed 20 per cent and in 2030 should not exceed 22 per cent.

To realize this objective several measures were used. I focus here on the main elements that intend to reduce public expenditure on the one hand and stimulate private – including occupational – pensions by tax and transfer incentives on the other. The last mentioned element was declared to be necessary because the public pensions as a means for financing living in old age alone would not be sufficient anymore in the future.

4.2.1 Redesigning the pension formula and its effect on the pension level

A central element for change was a redefinition of the pension adjustment formula aiming at a general reduction of the pension level. For example the pension level for the standard pensioner (45 Earnings Points) will be reduced from 70 per cent to 64 per cent in 2030. The emerging income gap should be filled by subsidized voluntary private saving up to a saving rate of four per cent from gross earnings if it fulfils several criteria (see below). This subsidized saving rate will be phased in using four steps (starting with one percentage point in 2002, ending 2008).

Regarding the pension adjustment formula the link to net average earnings was abolished. The elimination of the effect of income tax changes from the formula was especially important. When the net pension formula was introduced in 1992, it was expected that income tax rates on average will increase, therefore the development of net earnings development will be lower than for gross earnings development (which was decisive for pension adjustment since 1957). Compared to the early nineties meanwhile the strategy in tax policy has changed, reducing direct taxes and increasing indirect taxes (value added tax ecological taxes etc.). Reducing the direct tax burden would increase, however, pension adjustment rates based on the net earnings development.

Government implemented a new pension adjustment formula partially based on a proposal that was already published in the 1980s by the author and proposed again at the end of the 1990s by the Social Advisory Board of the German federal government:[39] According to this proposal only changes in the contribution rate to pension insurance will influence the adjustment rate beside the development of gross earnings. If pension insurance becomes more costly, this does not only burden contributors but pensioners as well (by lower pension adjustment rates). Government added, however, an additional factor to this formula, namely the voluntary contribution rate that the government expects employees to save for a private pension additionally in licensed forms. But nobody knows how many households will save and how much in reality. Nevertheless government decided on a contribution rate and implemented it in the pension adjustment formula.

The pension adjustment formula therefore is now in principle[40] the following:

$$P_t = \sum EP \cdot ARW_t$$

P_t = Pension benefit in year t

EP = Earnings Points

ARW = Amount in EUR for 1 EP per month

W^{ag} = average gross wage (earnings)

c = contribution rate in social pension insurance

ppc = contribution rate for private (certified forms of) pensions

The contribution rate for private pensions (ppc) started at one per cent and will be increased in four steps to four per cent of earnings by 2008. The intended effect of integrating this factor (ppc) into the adjustment formula for social insurance pensions (i.e. the development of ARW) is obvious: During the phase of increasing ppc, the pension adjustment rates will be reduced and by this the level of public pension benefits as well. This will affect all present and future pensioners. By this reduction of the pensions level a conflict emerges, as on the one hand there shall be a close contribution-benefit link in social 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 is no higher than a full social assistance benefit. This may negatively affect the willingness to contribute and may undermine the acceptance for such a mandatory scheme based on earnings-related contributions.[41]

To illustrate the effect of a generally reduced pension level one has to take into consideration two additional aspects:

(a) The full pension will be paid in the near future only if the insured person retires at age 65. Average retirement age today is about 60. There is a reduction of 3.6 per cent of the pension benefit per year of early retirement. From 2012 on, the earliest retirement age will be 62, equal for men and women.
(b) A full social assistance benefit amounts to about 40 per cent of net average earnings today.

With these factors in mind, Overview 5 gives some information on the ratio of pensions to net average earnings if the pension level for the standard pensioner (45 Earnings points) is reduced to 64 per cent as will be the result of the new formula. We can see for example that a pensioner with 35 Earnings Points retiring at age 62 has a net pension level that is only slightly higher than social assistance level. 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 about 25 Earnings Points (at a standard pension level of 70 per cent) if retirement is at age 65. In the future, when the standard pension level will be reduced to 64 per cent, about 28 Earnings Points are necessary and nearly 32 if retirement at age 62 is intended.

– Overview 5 –

How many Earnings Points a pensioner can accumulate during his/her working life depends especially on labour market conditions, periods of unemployment, part time and full time employment and earnings he/she received but also on the legal rules for crediting benefits.

It is worthwhile looking into the distribution of pension claims today and comparing it to social assistance as well as to the pension level of the "standard pensioner". Overviews 6a and 6b give some interesting information on this. There exists a remarkable difference between men and women (and in addition – not shown here – between blue- and white-collar workers and East and West Germany). Overviews 6a and 6b give the combination of average

Earnings Points of the pensioner and the number of insurance years for old-age pensions at the end of the year 2001. The pension is – as already mentioned – based on these two factors.

In each square of the diagrams the absolute number of the respective Earnings Points (average Earnings Points accumulated over the life cycle multiplied by number of insurance years) is shown. There are three indifference curves

(a) for pensions to be as high as social assistance in case of (aa) a standard pension level of 70 per cent respectively (ab) of 64 per cent, and

(b) for the standard pension (45 Earnings Points). In the German public debate this standard pension level is mostly the focus.

– Overviews 6a and 6b –

We can see from the graphs that hardly any women get the standard pension and that a substantial part of male pensioners also get less than the standard pension. Compared to social assistance level, a great percentage of women even today have a pension lower than social assistance. Reducing the pension level would increase this percentage.[42]

Looking at the new pension formula, it is obvious that it is relatively easy for government to make changes in the parameter of the pension formula to continue the reduction of the benefit level. The fictitious contribution rate for private pensions (ppc) can be increased which would lower the adjustment rate and therefore the level of public pensions. The Minister of Labour and advisors to the government have already mentioned such ideas. It can be expected that this would undermine (once more) the confidence in the public pension and the acceptance of the public scheme. It is not unrealistic to hypothesise that this is a hidden aim of some actors in the pension arena.

4.2.2 Reducing widow(er)'s pensions

The information above refers to pensions for insured persons. The benefit level of widow's and widower's pensions is reduced even more, namely by two effects:

(1) Widow(er)'s pensions are a certain percentage of the insurance pensions of the former spouse. The level of the insurance pensions will be reduced (as mentioned) and in addition widow(er)'s pension will be only 55 instead of 60 per cent of the insurance pension .[43] While pensions for the insured persons will be reduced by 8.5 per cent, the reduction for widow's pensions is 16.2 per cent.

(2) There is an additional effect: If the survivor's pension is above an allowance,[44] there is an income test, which now is based on earnings and own pension of the surviving spouse. This will be extended to all kinds of income (except the new subsidized private pension).

The idea behind this development is that widow's /widower's pensions should be phased out in the future in favour of own pension claims of women from earnings and additional credits for child care (today 3 Earnings Points per child are credited).[45] It is an open question whether the new percentage of 55 will be further reduced or the parameters of the allowance will be changed. 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.

It is not surprising that because of the benefit reduction in the contributory scheme there were plans for introducing new forms of minimum protection in old age. This was finally realized by the already mentioned means-tested transfer payment for elderly and disabled persons. Government originally planned to implement this tax-financed transfer payment into the social insurance pension scheme. There was, however, a lot of resistance. It was argued for example that the difference between pension claims based on own contribution payments[46] and means-tested transfer payments becomes more and more blurred in view of the persons covered. Now this minimum element is organized outside pension insurance on the local level and beside social assistance.

4.2.3 Effect on the development of contribution rates and rates of return

Regarding financing, 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 (see Overview 7). According to official projections, the necessary contribution rate in 2010 is one percentage point lower because of the reform measures, 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. However, regarding the contribution payments of employees the additional contribution rate for private pensions has to be taken into account if employees want to fill the gap that emerges because of the reduction in public pensions. It is obvious that right from the beginning the "total contribution rate" is higher. In 2010 and 2030 it will be three percentage points above the rate compared to the former conditions (i.e. without these reform measures).[47] These projections clarify that there is no Pareto-efficient transition from a PAYGO to a pre-funded scheme (Breyer 1989).

Prior to the reform a contribution rate of about 24 per cent was declared to be too high – now 26 per cent is politically acceptable. Has the "demographic crisis" of the pension scheme disappeared?

– Overview 7 –

Obviously the division of contribution payments between employers and employees will change.[48] The reduction of employer's contribution is, however, moderate: eleven per cent instead of twelve per cent in 2030. That means that the effect on non-wage labour costs is 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.

The partial substitution of PAYGO financing by capital funding will affect birth cohorts differently. Those who are already pensioners or near retirement have no chance to compensate the future reduction in public pensions. There are calculations by the German Federal Reserve Bank (Bundesbank) on changes in the rate of return for birth cohorts caused by the different reform measures (public and private pensions). These calculations are based on a number of assumptions that will not be discussed here. According to these findings only very modest changes result from the different measures (see Overview 8). Older cohorts will be burdened and younger cohorts will be the winners. However, the difference in rates of return is at maximum 0.2 percentage points. And it has to be recognized that the calculation refers to the year when cohort members will retire at age 65 (i.e. for persons born in 2000 retirement starts in 2065). The rate of return is higher in case of an earlier retirement age, because the deductions are less than actuarially fair.

– Overview 8 –

4.2.4 In summary: Main elements of the paradigm shift

Before dealing with the new private elements introduced by the 2001 pension reform the main elements of the paradigm shift are summarized:

– Instead of a fixed pension level and financing by contribution revenue and federal grant[49] being the dependent variable in social insurance, limiting the contribution rate now becomes the dominating objective. It is a shift from an “expenditure-orientated revenue policy“ towards a “revenue-orientated expenditure policy“. It can be expected that in case the contribution objective cannot be realized, the benefit level will be further reduced.

– Subsidized private pensions are not a supplement but a substitute for part of the public pensions. This becomes obvious by the direct link of contributions for private pension and the level of public pensions via the pension formula of social pension insurance. This partial substitute of public by private pensions also means that funding in part shall substitute PAYGO financing.

5. 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.[50] However, it has to be taken into consideration that persons being already pensioners or near retirement have no or hardly any possibility to close the income gap by additional saving for old age.

The original plan of the minister was to introduce a mandated subsidized private pension and there were no plans to extend subsidies to occupational pensions. Only after strong public opposition against mandating, government decided to organize it as a voluntary measure accompanied by incentives that 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. After the reform acts have been implemented, the minister now declares that no mandating will take place in the future.

Reacting to pressures particularly from trade unions, saving in some types of occupational arrangements is subsidized as well. In addition there is now also a right of the employee for conversion of 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 pensions need a certificate (see below) some types of occupational pension arrangements do not need this for being eligible for these subsidies.

5.1 Private subsidized pensions

Saving products have to fulfil several criteria to get the certificate, which is the precondition for becoming eligible for financial incentives. These criteria – together with incentives – shall prevent some negative distributional effects. Only a few criteria can be mentioned here:

- It is necessary to save regularly, but a break in payments is possible for example in the case of unemployment or long periods of illness. Then, however, no pension claims are collected in contrast to the social insurance pension scheme.
- In principle, there has to be a guarantee of the nominal value of own savings (after deducting the costs), which means that there is a guarantee of a nominal rate of return of zero by the supplier of the product, but no protection against inflation is guaranteed.
- The accumulated assets can be used when reaching retirement age or when claiming a disability pension.
- The accumulated saving must be paid out as a lifelong pension or as planned withdrawal up to the age of 85 and thereafter as a lifelong pension. No lump sum payments are allowed.[51] Otherwise the subsidy has to be paid back.[52] This criteria 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 (costs cannot be deducted from contributions mostly 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, negative effects on rates of return are mentioned in particular. 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. As of the beginning of 2002, products with certificates are offered by insurance companies, banks, and investment funds. The decision to grant the subsidy is made by a new public administration (which will have about 1000 new 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 household. Both elements are aiming at exempting the contributions for saving in these products from income tax (but not from social insurance contributions.[53]) Interest on investments will be exempt 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 prior saving (for example at age 65 only 27 percent of the pension are taxable income).[54]

The subsidy is especially attractive for persons with low income, for couples with only one person earning income and for families with children, because there is an additional allowance for children which is higher than the basic allowance for each spouse. 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 when four per cent of earnings are saved (if saving is less, the subsidy is cut proportionally).

Employees are now confronted with a huge number of different products. Often insurance companies offering certified products see it as a possibility to “open the door“ for additional products they want to sell. First experiences with misselling have been reported. There has been a lack of transparency concerning costs of the different products. There exists 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 will be lower compared to individual contracts.

5.2 New possibilities in occupational pension arrangements

As mentioned above (section 2) there were four fundamental forms of occupational pensions and a great variety in the design of pension plans. 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. In addition, some new possibilities for occupational arrangements were created linked to a new right for earnings conversion and by the introduction of "pension funds". These measures should stimulate the sluggish development of occupational pensions.

Earnings up to 4 % of the contribution ceiling in social pension insurance can be converted into a pension claim.[55] In case of earnings conversion there are also possibilities that these earnings components are exempt not only from income tax but also from social insurance contributions up to the year 2008. This has several additional effects on the financing of social insurance and on the possibility for employees to accumulate Earnings Points. Earnings conversion without paying contributions on this amount will reduce the individual public pension in addition to the general benefit reduction. This effect has hardly been recognized in the German debate thus far.[56] Further, contribution revenue is reduced. This depends on how much of the sum of contributory earnings will be converted.

The different types of incentives can be used in addition if persons can afford to save higher amounts. This already points at some distributional effects that will be taken up later.

As mentioned above, in the private sector hardly any collective agreements on occupational pension arrangements existed. This is changing in a number of important industries (for example the chemical and metal industries) and 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 information provided for investment) it can be expected that many employees will choose this way instead of a private pension. However, there is no empirical data yet on how employees will decide.

Employees are now faced with a great number of new alternatives for subsidized saving for old age (see Overview 9). Saving can be:
(a) private saving – up to 1 percent of earnings (2002) increasing to 4 percent (2008) – from net earnings in certified products and being eligible for subsidy or tax exemption (in Germany these pensions are named "Riester-pension" after the present 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 direct insurance with a flat rate tax of 20 percent (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 by holiday or Christmas money).[57]

– Overview 9 –

This is not at all transparent. The decision process necessary for employers and employees is complex and difficult. But it is a real stimulus for activities of consultants. There are no empirical results available yet, because the new rules became effective only in 2002.[58]

Regarding occupational pension in addition to the already existing four types[59] a fifth type has been established: pension funds. In contrast to already 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.[60] 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 capital from self-financing to the capital market. Meanwhile, the collective agreement on the public sector was changed as well. 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 the occupational pension, in the future employees will have the possibility of saving in a defined contribution type of pension eligible for subsidies. But that means no benefit level is guaranteed anymore.

6. Some lessons, implications and effects of the shift towards private and occupational pensions

The new rules in pension policy in Germany were enacted from the beginning of the year 2002, some measures will be phased in during the next years. It is too early for a comprehensive evaluation of the reform measures. However, some effects seem to be obvious and some others likely. There is a clear tendency to reduce the benefit level in social insurance. This is done by a general reduction of the pension level via the pension adjustment formula as well as by changing conditions for disability pensions and for survivor's pensions. Taking into consideration the changes in many other countries, it is not surprising that minimum elements become an integrated element of pension policy (the means-tested tax financed pension). Private pensions as a substitute to public pensions are at present voluntary. But at least in the case of a low participation of employees in the new possibilities for saving in certified pension products or using the possibilities via collective agreements and/or in case the benefit level in public pensions will be reduced even more than declared today, the topic of mandating private pensions will be put on the political agenda. Such mandating may be based on industry-wide collective agreements (quasi-mandating) or mandating by law.

A combination of low public PAYGO financed pensions and mandatory private funded elements is to be seen in many countries. This is in line with a strategy the World Bank is proposing world-wide (World Bank 1994), although with some modifications depending on country-specific circumstances. A further push towards reducing public PAYGO pensions can be expected at 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 about the sustainability of fiscal policy and of pension policy and the need for intergenerational equity. The focus here is mostly on reducing PAYGO financing (Schmähl 2002). These seem to be important political arguments, although one can debate the rationale of this.

Another influencing factor coming from the European level may be a result of the ongoing process of implementing an open method of co-ordination in pension policy by deciding about common goals in pension policy and on a set of indicators being the base for benchmarking pension policy of the member states. This will depend on the decision about which indicators are chosen. Taking the important role of the ministers of economics and finance (ECOFIN) into account it may happen that for example indicators like the public pension percentage of GDP will play an important role in such a set of indicators. It is obvious that the ministers of finance are looking at the "burden" for public households, rather than 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 in how the pension arrangements in the member countries will be evaluated. This process is not yet finished, but it may become a decisive component in the national pension debate and influence the mix of pension schemes on the national level.[61]

Regarding the public pension scheme in Germany it does not seem 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 of not being realized. Such a further reduction of the benefit level would make the conflict between pension level and desired structure of the scheme even more obvious. Will it be possible to achieve politically 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 expect only a pension below or hardly above the social assistance level? A development towards basic pensions with strong redistributive elements will then be a realistic assumption. Germany today is still a country with an earnings-related public pension scheme aiming at income smoothing over the life cycle and not only at avoiding poverty in old age and has voluntary funded pensions (for example as a 2nd tier or supplementary occupational pensions) – see Overview 10. It may not be totally unrealistic that a shift in the 1st tier towards primarily avoiding poverty takes place and then in the 2nd tier towards mandating. These developments may influence each other. Such a pattern (public flat-rate pensions or with a low pension level together with mandated 2nd tier) can be seen in many countries like the Netherlands or Switzerland.[62] The development in these countries is often mentioned in Germany as an attractive model for pension policy. But often only those elements of the arrangements are highlighted that are in accordance with the aims and proposals of those who draw on foreign experience.[63]

– Overview 10 –

The now emerging private and occupational pension arrangements in Germany are complex and complicated. It may be that after the first experiences some changes will take place. Employees are faced by very complex decisions. The assumption is not unrealistic that many employees will choose the way via earnings conversion and employer-based pension arrangements because of lower costs and higher incentives (at least during the next few years). Occupational pension arrangements have already become, after the 2001 reform decisions, an important element in collective bargaining. For a long time trade unions had little interest in occupational pensions. Now, they see here a new field for activity in a period of decreasing influence of trade unions. This interest in occupational pension arrangements based on collective agreements may be important because of possibilities to influence investment decisions in the new industry-wide pension funds that are to be established. Will we see a trend towards “pension fund capitalism“ which Peter Drucker (1976) mentioned some decades ago? It is, however, too early to have any hard facts on this.

The structure of occupational schemes in the private as well as in the public sector is changing from defined benefit to defined contribution. It can be expected that financing of occupational pensions will now be mostly by employees instead of employers as it was in the past. The tendency towards defined benefit will shift the risk from employers to employees.

The new strategy in pension policy will have a lot of effects that are important 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. It can, however, be expected that the distribution of income in old age becomes more diversified and inequality in old age will increase. The developments in the UK give some indication of this.

There are many factors relevant for the effect on personal income distribution like the possibilities to save and to take up several types of subsidies together, the investment decisions and their return as well as the costs linked to low and higher amounts of saving. With regard to the new incentives for saving it is an open question whether and how much additional saving can be expected. Experience from former attempts to stimulate saving point at a high rate of substitution within different types of saving from non-subsidized to subsidized types or towards higher subsidies.[64] Actors on the financial market expect a shift between types of saving towards equities. It is expected that the tendency towards 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 of occupational pensions based on book reserves and a shift towards capital funding. This advertising – supported by many politicians as well as academics and by the mass media – was obviously successful. But there are already demands for doing more in this direction, including mandating private pensions.[65]

Those who can afford to save will profit from the new (or additional incentives). As already mentioned, there will also be the possibility of using different types of incentives for private pension and via earnings converging together. This, however, requires an income that is high enough to use several possibilities. Persons with low income may not have enough money to save in these privileged types of saving. A remarkable percentage of all German households (at present about nine per cent) are heavily indebted and cannot meet their financial liabilities (their obligations to pay back the accumulated debt although they have already reduced their living conditions). If they have some spare money, it will be preferable to reduce their debt instead of saving in subsidized form.

What is neglected today in public discussion is that these incentives have to be financed too. If tax expenditure for incentives to save is financed mostly by indirect taxes (like VAT or tax on petrol etc.) all households have to finance the incentives, including households with low incomes and those households that are not able to profit from the subsidies. Further, households with many children face a relatively high burden through indirect taxation. This reduces part of the bonus they can get via the subsidies.

There remain many open questions regarding the effects of the new strategy in Germany's pension policy and we would expect in the near future further debates about pension policy in Germany. One reason is that there are at least two important topics that were explicitly excluded from the 2001 reform package, income tax rules on pensions and the development of retirement ages. As already mentioned, there is now the necessity to change income tax rules because of a decision of the Constitutional Court. There is – after the reform decisions taken in 2001 – a debate at the national as well as European level on the labour force participation of older workers. The rules for when and under which conditions retirement pensions can be taken are a relevant topic. Taking into consideration, among other things, the increasing life expectancy an increase of retirement ages for claiming the full pension without deductions seems to be a necessary measure to cope with challenges of demographic ageing.[66]

Germany's pension arrangements are in the process of transition. It will be decisive whether in the future a further trend towards private pensions will be a substitute for public pensions. Germany seems to have passed a crossroad. But how far we will go ahead in the direction politicians have now declared as the only way to solve future problems in pension policy depends on future economic and political developments.

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[1] These economic arguments were already developed in a think tank during the late thirties and the early forties, but when presented after the war this was not mentioned at all. On the origins see Schmähl (1981).

[2] This is so for pension insurance, health and long-term care insurance as well as unemployment insurance. Only in accident insurance employers pay the total contribution themselves.

[3] However, there is a difference between paying a contribution and being burdened by the contribution payment (effects of forward or backward shifting). With regard to shifting it is argued that possibilities of firms to shift costs have become much more difficult due to intensified international competition.

[4] Most prominently by Kurt Biedenkopf, who became Prime Minister of the state of Saxonia after German unification.

[5] Schmähl (1993a) gives an overview of proposals for flat-rate pensions in Germany to be financed by taxes or contributions. A very early proposal in Germany for a contribution-financed "poor man's insurance" was made by Leopold Krug in 1810; see Schmähl (1997b).

[6] The political process resulting finally in the reform package with many interesting and surprising features is discussed in Schmähl (forthcoming).

[7] Formal in contrast to informal arrangements, especially intrafamily pension provision.

[8] In addition also measures in case of rehabilitation are financed.

[9] As already mentioned, social insurance for miners is an integrated scheme of first and second tier. The same is true for civil servants' pensions, however pension calculation differs between these two schemes.

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

[11] 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 mandatorily 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).

[12] 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, without book reserves 6.3 %. 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 its links to the first tier pension schemes, see Schmähl (1997a) with further references.

[13] This has existed in the building industry for some decades.

[14] The data is based on the official "Social Budget" of the Federal Government. It does not include tax expenditure linked to pension arrangements as well as private provision for old age, saving, life insurance etc. (the 3rd tier). In addition Overview 2 gives an estimate of private saving for old age via life insurance.

[15] In Germany long-term care insurance was introduced in order to avoid social assistance in cases where a person needs long-term care (Schmähl and Rothgang 1996). While the number of people who need social assistance declined after the introduction of the new mandatory insurance, the number is already increasing because the benefits of long-term care insurance have been unchanged since the introduction in 1995.

[16] Depending on income and assets of children.

[17] For several phases of post-war pension reform in Germany see Schmähl (1998a).

18 At present average retirement age is just below 60 years, while the entrance into the labour market is, however, above age 20. Average retirement is not identical with the average age of exit from the labour force because of pre-retirement possibilities. In Schmähl et al. (1996) the different pathways out of the labour force are discussed. The average retirement age is among other factors also influenced by the number of cohort members which has to be taken into account when looking at its development over time.

19 (Net-)Migration can reduce the ADR if the age structure of migrants is "younger" than the population living already in the country of those who emigrate. Based on recent experience such an effect can be assumed. However, regarding the Pensioner Ratio it is essential that these people can be integrated into the labour market.

20 ADR (20/60) gives the beginning of the phase of ability to work (20) and of beginning of "retirement" (60).

21 Contribution rate for social pension insurance (blue- and white-collar workers) 19.2 % (1996), 20.3 % (1997, 1998 and first quarter of 1999), 19.5 % (1999 as of 1st April), 19.3 % (2000), 19.1 % (2001 and 2002).

22 For a discussion of this argument see Schmähl (1995).

23 Federal Government declared as an objective to reduce total social insurance contributions to below 40 per cent (in 2001 it was 42.2 per cent).

24 In the public debate civil servants' pensions are hardly a topic. That does not mean that there are no changes. On the contrary, these pensions are reduced much in line with reductions of social insurance pensions. That means that the development in social insurance has become a guideline for retrenchment while during the phase of expanding

pension schemes rules for civil servants were the guideline for developing social insurance pensions.

25 In this sense for example Siebert (1998) – member of the “German Council of Economic Experts” of the German Federal Government –, Neumann (1998) as chairman of the Scientific Advisory Board of the Federal Ministry of Economics and as well this Board (Wissenschaftlicher Beirat (1998). For a critical review of these statements Schmähl (1998b and d).

26 For a critical analysis of negative effects of “welfare states” on economic growth see Atkinson (1995).

27 HypoVereinsbank (2001) and Merrill Lynch (2000)

28 For example in Schmähl (1980).

29 On rate of return comparisons and their contents for social policy decisions see Viebrok and Dräther (1999).

30 Schmähl (1996).

31 See for example Sinn and Übelmesser (2000).

32 See again as a prominent example Wissenschaftlicher Beirat (1998).

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

[34] For a formal presentation of the pension formula see Schmähl (1999a).

[35] There exists 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 its introduction in 1972.

[36] It covers about 20 % of all expenditure of social pension insurance.

[37] That is for three years on the base of average gross earnings. For a detailed analysis of various links between social pension insurance and another public budgets see Schmähl (2001a).

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

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

[40] There will be a further change in the parameters in 2011.

[41] This conflict is highlighted by the Enquête-Commission of the German Federal Parliament on Demographic Development (Enquête-Kommission 2002, p. 154).

[42] Whether these pensioners are or will be eligible for means-tested social assistance or the new means-tested transfer payment in old age, depends on the income (and assets) of the household. However, this information seems highly relevant with regard to willingness to contribute to the scheme and the acceptance of such a mandatory scheme.

[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.

[44] Original plans of the government were to freeze the absolute amount of the allowance. It now remains earnings-related.

[45] A detailed discussion on pensions for women is in Schmähl and Michaelis (2000).

[46] Such pension claims are constitutionally protected according to decisions of the Constitutional Court in Germany as types of individual assets.

[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 by indirect taxation) these households. This will be taken up below.

[48] The question of shifting employer's 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] Which depended on the development of earnings as well as the contribution rate of the public pension scheme. Federal grant is for financing expenditure aiming at interpersonal redistribution.

[50] Nevertheless government rejects the idea that private pension in part should substitute public pensions. The official statement describes these pensions as a supplement to the public pension; see for example Riester (2002), p.30. by

[51] With the exception of at maximum 20 % of assets at retirement age.

[52] 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.

[53] Up to the year 2008, there exists, however, a specific possibility that in case of earnings conversion this part of earnings is exempted from social insurance contributions. This will be explained below.

[54] On 6th March, 2002, the Constitutional Court decided that these 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 provision for old age.

[55] The contribution ceiling is about 180 percent of average gross earnings. Therefore, saving of 4 per cent of earnings at the ceiling is about 7 percent compared to average earnings.

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

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

[58] 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 more than 15 million employees who are eligible to use the existing possibilities (Süddeutsche Zeitung 13th February, 2002).

59 Direct pension commitment (based on book reserves); pension insurance funds; support funds; direct insurance, see (2.).

60 While, for example a pension insurance fund only can invest up to 35 percent in equities.

61 For more aspects concerning this process see Schmähl (2002).

62 For a comparison based on this typology see Schmähl (1991b).

63 For example, the basic tier (AHV) in Switzerland is often 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 often it is neglected, too, that occupational pensions are mandatory.

64 Börsch-Supan and Essig (2002), p. 93, also raise some doubts whether the subsidies will create any additional saving.

65 In this sense an "institute" – named "German Institute of old-age provision" (Deutsches Institut für Altersvorsorge) has been established and financed by the Deutsche Bank.

66 The author proposed to link retirement age to the increase in life expectancy to divide additional years of life between working years and years in retirement. Changing the retirement age, however, requires several preconditions in order to become effective and socially acceptable, among other things further education and retraining of older workers.

For a discussion of this topic see Schmähl and Viebrok (2001), Schmähl (2001b) with further references.