Report of the German Social Advisory Council on the Federal Government's 2006 Pension Insurance Report

Contents

I. Introduction

1. In accordance with its statutory duty (section 155, Social Code, Part VI), the German Social Advisory Council (GSAC) comments on the Federal Government's 2006 Pension Insurance Report. This statement addresses firstly economic development in 2006 as well as political measures regarding pensions discussed in the 2006 pension insurance report. Thereafter, the details of the 2006 pension insurance report that refer to future development, i.e. projections over the medium term and the model calculations for the next 15-year period, are addressed.

2. The GSAC makes its comments based on its access to the calculation results and to information on underlying assumptions as well as to the text of the 2006 draft report on the pension insurance scheme. For its assessment of raising the pension eligibility age and the design of the modification to the protection clause, the GSAC has relied on the draft legislation on adjusting the pension age in response to demographic changes and in order to strengthen the financial basis of the statutory pension insurance (Pension Insurance - Retirement Age Adjustment Act, *RV-Altersgrenzenanpassungsgesetz*) and the planned contribution rate rise in 2007 that was agreed in cabinet on November 2, 2006, as well as pre-existing formulations of the draft law on fixing the contribution rates in the statutory pension scheme and the

contributions and contribution subsidies in the agriculture pension scheme for 2007. The GSAC was also able to approach the Federal Ministry of Labour and Social Affairs for additional information and explanation.

II. Economic Development in 2006

3. In 2006 the German economy experienced a strong upswing. According to the forecast from the German Council of Economic Experts (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung,* SVR), gross domestic product (GDP) grew from 0.9 percent in 2005 to 2.4 percent in 2006. Compared to previous years, growth in GDP was brought about not only through exports but also through a stronger domestic economy. This saw the contribution made to growth by domestic demand for the first time outstrip the contribution from foreign trade, which continued to grow and which in recent years has underpinned the economic cycle. In comparison to 2005, real foreign trade rose again by about 0.6 percent. The growth in domestic demand was underpinned by the growth in infrastructure investment (4.4 percent) and the rise in total consumer expenditure (0.9 percent) that saw private and government consumer expenditure each increase by 0.9 percent. This considerable rise in private consumer expenditure since 2002 could at least partially be attributed to purchases made in advance of the rise in VAT in

2007. As far as construction investments are concerned, the lengthy decline apparent since 1999 appears to be over. These investments have climbed about 2.5 percent and have benefited from advance investment in house building.

4. The improved economic situation has also influenced the labour market. There the situation has eased. According to figures from the German Federal Employment Agency, the unemployment rate among the total civilian workforce was 9.8 percent in October 2006 compared to 11 percent the previous October. In absolute terms, the number of unemployed declined by about 470,500 to about 4,084,500.

5. The economic upswing also had a positive effect on the number of those in employment. There was a slight increase compared to the previous year. It is especially welcome that this year the fall in those in employment liable for social insurance contributions could be halted. For the first time in several years an increase was once again visible. This decline led to a seasonally adjusted figure of those in jobs liable for social insurance contributions of about 25.8m in February 2006, its lowest level ever. From March onwards, this figure rose by almost three-quarters of a million to reach about 26.6m in August 2006. This represents one percent more people engaged in work liable for social insurance contributions compared to the corresponding month the previous year.

6. In recent years a noticeable difference between the old and new federal states (former West and East Germany) in the development of jobs liable for social insurance contributions has been apparent. While the old federal states suffered “only” a one percent decline in the number of jobs liable for social insurance contributions, the new federal states saw a decrease of about 3 percent. The actual figures suggest that the economic upswing also had a positive effect on the jobs market in the new federal states. The old as well as the new federal states benefited to the same degree from the increase in jobs liable for social insurance contributions.

7. The growth in jobs liable for social insurance contributions also had a positive effect on the financial situation of the pension insurance. The effects cannot be determined exactly due to the fact that the increase in compulsory contributions can be attributed to many factors: the number of jobs liable for social insurance contributions; the development of wages and salaries liable for social insurance contributions and the additional revenue that arises from bringing forward the payment date for the total social security contribution. In total, the increase in revenue from compulsory contributions in the first ten months of 2006 outstripped the same ten months of the previous year by about €11.5bn. This additional income is based, primarily, on the payment date for the total social security contribution having been brought forward. Considerable uncertainties surround any comparison with the previous

year in regards to a period of less than 12 months. For example, the contributions received in October 2006 relate to wages and salaries in the same month. In October 2005 contributions received still mostly related to the previous month's salaries liable for insurance contributions. The financial effect of bringing forward payments in 2006 is given as about €10.5bn in total. In 2006 the contribution revenue of the statutory pension insurance that comes from the German Federal Employment Agency will decrease by about €0.8bn in comparison with 2005. Taking into account other types of contributions, the total contribution revenue for 2006 rose by about €10bn in comparison to 2005.

III. The Federal Social Court's judgment on deductions within pensions for reduced earnings capacity

8. The legislator has abolished the vocational disability pension (*Berufsunfähigkeitsrente*) and has made changes to the disability pension (*Erwerbsunfähigkeitsrente*) to create a two-tiered pension for reduced earnings capacity (*Erwerbsminderungsrente*). These were central elements in the law on reform of pensions for reduced earnings capacity that was passed in 2000. Under the new regulation, individuals who are unable to work at least three hours a day can claim a full pension for reduced earnings capacity. Individuals who are still able to work between three and six hours a day can claim half of the pension for reduced earnings capacity.

For this group, pensions for reduced earnings capacity that are granted depending on the labour market situation (the so called concrete assessment procedure) remained in force due to the unfavourable labour market situation. This means that an insured person with a partially reduced earnings capacity receives the full reduced earnings capacity pension if he or she cannot find employment. In order to compensate the statutory pension insurance for assuming the labour market risk, the Federal Employment Office gives a lump sum to reimburse the pension insurance for half the cost of paying out reduced earnings capacity pensions and the corresponding contribution to the pensioners' health insurance scheme. This obligation to reimburse is limited to the period that unemployment benefit is claimed.

9. It is possible to claim the reduced earnings capacity pension without deductions once the insured person has reached the age of 63. The insured has to accept a deduction amounting to 0.3 percent for each month he or she draws a reduced earnings capacity pension before the age of 63. To ensure that the deduction is not higher than 10.8 percent, the lower age limit of 60 is set when calculating deductions. The deductions are intended to stem potential behavioural changes likely to be caused by the general introduction of deductions for early retirement. Without deductions, the legislator saw a possible loophole for those with reduced earnings capacity and therefore deductions for reduced earnings capacity pensions were introduced that correspond to

the deductions for claiming an old-age pension early. When determining the benefit level for those with reduced earnings capacity, deductions preclude any potential benefit from taking early retirement between the ages of 60 and 63.

10. Although younger recipients of a reduced earnings capacity pension also suffer a 10.8 percent deduction, this is, as a rule, mostly compensated for by expansion of the non-contributory supplementary period (*Zurechnungszeit*), which came into effect at the same time as the deductions were introduced. The full period between the point when the reduction in earnings capacity began and the person reaching 60 is regarded as a non-contributory supplementary period. When determining the pension, it is assumed that the person concerned would have been in employment liable for contributions until the age of 60 and would have received a salary that corresponds to the average of his or her previously earned income liable for insurance contributions. Prior to the reform of pensions for reduced earnings capacity, the years between the ages of 55 and 60 only counted for a third. Thus, for those insured that draw a reduced earnings capacity pension before the age of 60, the deductions are mostly compensated for by the simultaneous expansion of non-contributory supplementary period.

11. On May 16, 2006 the fourth senate of the Federal Social Court ruled on an appeal over whether a deduction should also

apply to those insured entitled to a reduced earnings capacity pension but who are below the age of 60. In the case concerned, the claimant, born in August 1960, temporarily – from March 2003 onwards – drew a pension for full earnings incapacity. This pension was reduced by the German Federal Pension Insurance Institute (*Deutsche Rentenversicherung Bund*) – taking transitional arrangements into account – by 8.1 percent. The fourth senate ruled that the claimant should receive a full pension without any deductions. The Federal Social Court argues that one cannot assume that people below the age of 60 partially or fully incapable of work deliberately choose to retire early. In the Federal Social Court's opinion, neither in the law as it was conceived nor in its practice can one find a basis for a regulation that reduced earnings capacity pensions paid out before the insured has reached the age of 60 should be subject to any deductions.

12. The GSAC is of the opinion that both the law and its explanatory notes suggest that the level of payment of the reduced earnings capacity pension should be brought into line with the severe disablement pension claimed before the normal retirement age. The legislator's intention to use deductions to align the reduced earnings capacity pension claimed before the insured reaches the age of 60 with the severe disabled pension claimed early is demonstrated not only through the regulation regarding deductions but also through the expansion of the non-contributory supplementary period. According to the explanatory notes of the law,

increasing the non-contributory supplementary period up to the age of 60 acts to moderate the effects of deductions on the younger insured. The concrete effects of the deductions on the level of pension received for persons who retire on a reduced earnings capacity pension before reaching the age of 60 are also shown in the explanatory notes of the law.

13. In the opinion of the GSAC, the Federal Social Court's judgment made on May 16, 2006 formulates a completely new interpretation that contradicts the intention of the law. Therefore, the GSAC supports the statutory pension insurance institutions' view that beyond this particular case no universally valid meaning can be attached to this judgment.

IV. Raising the pension eligibility age to 67

14. Based on the coalition agreement of November 18, 2005 the coalition working group for implementing the measures for old-age pension provision decided on October 23, 2006 on some agreements and preliminary decisions and corresponding changes in regard to "Pensions from 67 onwards". In the meantime, draft legislation on adjusting the pension eligibility age to the demographic development and on strengthening the financing bases in the statutory pension insurance scheme (Pension Insurance - Retirement Age Adjustment Act; *RV-Altersgrenzenanpassungsgesetz*) that implements the resolutions made by the coalition working group has been presented. The

draft law is due to be passed on November 26, 2006 by the cabinet and to be discussed in the Bundestag before the end of 2006.

15. The draft legislation on the Pension Insurance - Retirement Age Adjustment Act (*RV-Altersgrenzenanpassungsgesetz*) that raises the statutory retirement age by two years includes a number of exceptions. Here it must be mentioned that a new opportunity to retire at the age of 65 without deductions exists if an insured person has 45 years of compulsory contributions from employment, self-employment, from long-term care periods and from child raising periods until the child reaches the age of 10, while the opportunity to retire on a reduced earnings capacity without deductions is retained if the insured can show either 35 or 40 years of the above.

16. The draft legislation allows the retirement age to be raised gradually from 2012 until 2029 until the target of 67 is reached. In the first 12 years - from 2012 to 2023 - the retirement age rises by one month per birth cohort. Thus, in 2023 the pension eligibility age stands at 66. In the period between 2024 and 2029 the pension eligibility age should rise by two months per birth cohort until the pension eligibility age of 67 is reached in 2029. Thus, all insured born from 1964 onwards can only retire at the age of 67 or face pension deductions.

17. The effects of raising the statutory retirement age on the statutory pension insurance’s financial situation cannot be quanti-

fied exactly. The later retirement age for new pensions leads to a reduction in expenditure. In comparison with the status quo, lengthening the working period will provide additional income for the statutory pension insurance. But in the long term this has to be seen alongside higher pension entitlements for the insured due to a longer working life. For an exact calculation, a long-term projection of new pensions and those already in effect is necessary, but such a projection is decisively influenced by the future situation of the labour market as well the behaviour of employers and the insured. Raising the retirement age is likely to reduce the increase in the contribution rate until 2030 by 0.5 percentage points, taking into account the exception that allow the insured to retire at the age of 65 without deductions if they can show 45 years worth of contributions.

18. A labour market political supporting scheme for the increase of the pension eligibility age has been codified in the coalition agreement and has now already been implemented by the government through several measures. Thus, for example, the “Initiative 50plus” passed by the federal cabinet in September 2006, is aimed at a broad change in awareness and attitude in society by employing selected promotional measures. These also concerned reducing prejudices about the qualifications, motivation and capabilities of older workers. Through two initiatives – “Perspectives 50plus - Employment agreements for the Elderly in the Regions” and “30,000 Additional Jobs for Those over 58” – special pro-

grammes were set up to reintegrate the older long-term unemployed into the labour market.

19. At least some of the insured will, in the long term, profit financially from the increase in the retirement age. On the one hand, raising the pension eligibility age moderates the contribution rate increase; on the other hand, pension entitlements will increase for those insured who work longer. While higher pension entitlements are a result of a longer working life during which the insured gain additional earning points, however, because of the increase in the statutory pension eligibility age, the numerical ratio of pensioners to the employed turns out to be relatively more favourable. This results in - other things being equal - a higher adjustment of the current pension value via the sustainability factor in the pension adjustment formula. This effect is strengthened as the contribution rate is lower as a consequence of the increase in the pension ages that, in turn, results in a higher pension adjustment. In this respect the statement that the increase in the pension eligibility age by two years is tantamount to a general pension reduction of 7.2 percentage points is unfounded. However, for those insured who are not able to work longer the increase in the retirement age results in financial penalties.

20. The increase in the statutory pension age by two years is an answer to increasing life expectancy and because of this a longer pension payment period. During the past 40 years, this period has

increased on average by about seven years to be 17 years. Therefore, the increase in the pension eligibility age is an important measure to reach the statutory contribution rate and pension level targets set for the periods until 2020 and 2030.

21. The future life expectancy of a 65-year-old will increase between 2010 and 2030 by a further two years. Thus the average pension payment period remains unchanged due to the increase in the retirement age. Therefore the belief that pensioners who retire from 2029 onwards have something “taken away” from them because of a reduction in the pension payment period is unfounded.

22. It is the GSAC’s view that the increase in retirement age should, nevertheless be supported more intensively than until now with employment and labour market policy, measures regarding further training as well as health measures aimed at prevention and rehabilitation so that the employment rate of the older employed will increase. In this way the increase in retirement age should not lead to a “hidden pension reduction”. This is paramount since employment rates among older workers are currently not satisfactory.

V. Effects of the increase in the pension eligibility age on the pension adjustment in the statutory pension insurance

23. The age limit allowing retirement on a pension without deductions is raised incrementally from 65 to reach 67 by 2029. Taking into account exceptions, raising the retirement age moderates the rise of the contribution rate until 2030 by 0.5 percentage points. As a consequence of either retirement being postponed or higher deductions in case of early retirement, total pension expenditure turns out to be lower therefore a lower contribution rate is sufficient to finance the pensions.

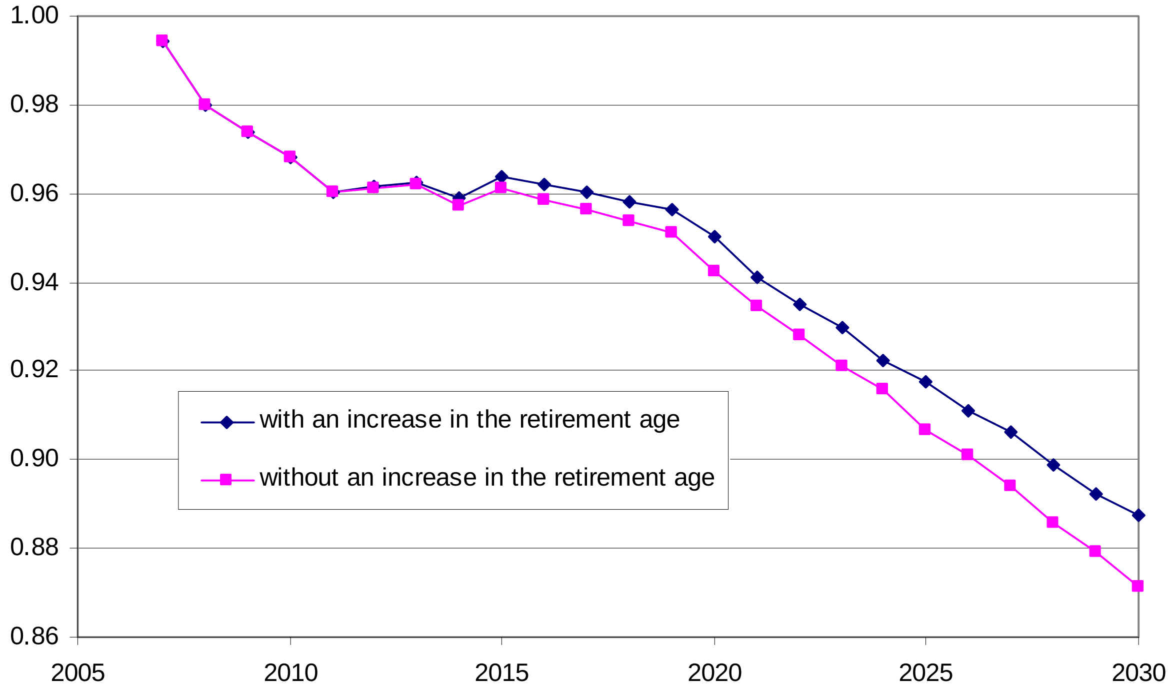
24. In addition, raising the retirement age leads to higher pension adjustments provided that wages develop at a corresponding rate, as both of the moderating factors – the change in the contribution rate and the sustainability factor – have a lesser effect in the pension adjustment formula. Therefore, in 2003 the decline in the gross pension level is lower by 0.6 percentage points. Raising the retirement age moderates the contribution rate increase and as a result the pension adjustment is moderated, but to a lesser extent. Thus, on the whole pension adjustments turn out to be higher by a total of just under 0.9 percentage points until 2030.

25. The sustainability factor also has a weaker impact because of the raising of the retirement age. This factor carries over changes in the ratio of equivalence pensioners to equivalence contributors

– multiplied by a factor of 0.25 – to the pension adjustment.[1] Here, raising the retirement age is effective via a lower number of equivalence pensioners or via a higher number of equivalence contributors: if retirement is postponed and contributions continue to be paid, the number of pensioners declines but the level of the average pension increases so that the number of equivalence pensioners remains, ultimately, almost unchanged. However, the ratio of equivalence pensioners to equivalence contributors would decline as the number of contributors increases. In contrast, if retirement is taken at 65 or under then the number of contributors also remains unchanged. But in this case, the number of equivalence pensioners declines because of the deductions due. Only when all pensions in existing pensions are based on the new regulations (stationary state) the actual effects can fully develop.

[1] To avoid biases when employing the sustainability factor, for example because of the expansion of part-time employment, the number of contributors and pensioners are standardized to equivalence figures (number of average earner and number of standard pensioner respectively).

Figure 1: Factor of the combined effect of contribution rate change, “Riester-Steps” and sustainability factor on the development of the current pension value until 2030 (Basis: the 2007 pension adjustment before the effects of the moderating factors).



26. As a consequence of these correlations, the impact of the sustainability factor is reduced by 1.1 percentage points until 2030. The joint moderating impact of the sustainability factor and the change in contribution rate is lessened by just under 2 percentage points by raising retirement ages: due to the increase in the retirement age, the current pension value is adjusted more starkly, by 2 percent until 2030. About half of this positive effect results from the sustainability factor and just under a half from the change in contribution rate.

27. As a result, the positive financial effect due to the retirement age being raised and the corresponding impact - via the pension adjustment formula - on the contribution rate also results in a less

pronounced decline of the pension level. This effect on the pension level is not shown just in the calculation result of the pension adjustment formula but also follows the general trend of the moderating factors. The charge borne by the employed caused by higher pension contributions is carried over to pensioners as well. If the contribution rate rises to a lesser extent, moderation of the pension adjustment is, accordingly, lower. The sustainability factor is intended to take changes in the ratio of contributors to pensioners into account when the pension adjustment takes place and thus to distribute justly any burdens among the generations that are caused by the ageing of the population.

VI. Effects of the increase in the pension eligibility age on the rate of return in the statutory pension insurance

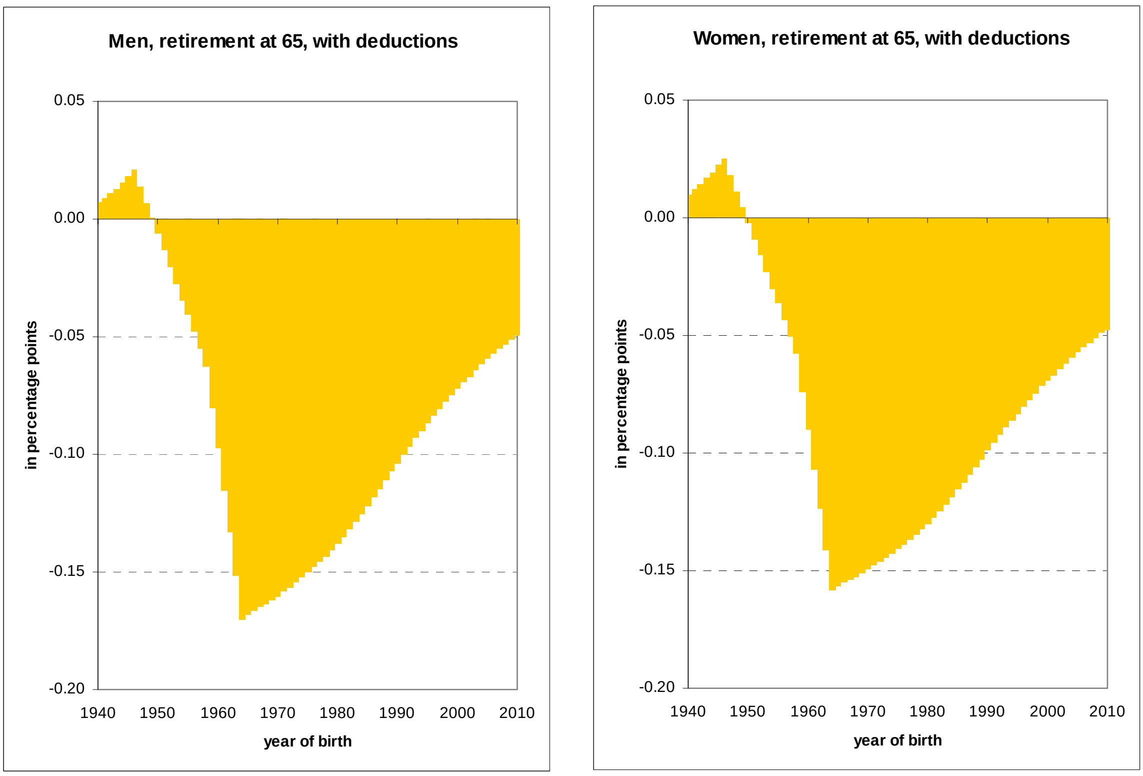
28. The incremental raising of the statutory retirement age also affects the pension insurance's implicit rate of return through the contribution and benefit side. If the actual retirement age remains at 65 from the end of 2029 onwards, deductions of 7.2 percent are due if retirement is taken two years earlier. But this reduced pension is seen alongside a lower contribution rate – in comparison with the situation that would arise without pension eligibility ages being raised. Furthermore, it must be noted that the pension adjustment is increased through, firstly, the effect on the sustainability factor caused by a lower increase in the pensioner-contributor ratio and, secondly, through a lower contribution rate

increase. While the remaining benefit reduction does have a negative effect on the rate of return, the lower contribution rate has a positive effect. In individual cases, the rate of return depends decisively on how long the lower contributions are paid. For example, those insured who retire in 2030 are subjected to the full deductions but are only able to profit to a limited extent from the contribution rate moderating effect of raising pension eligibility ages. Their contribution payment history is likely to have begun in the mid or late 1980s while pension eligibility ages only rise from 2011 onwards. Therefore, for a relatively long transitional generation, those born between 1950 and 2030, a lower rate of return has to be anticipated.

29. If retirement starts after the age of 67, the insured qualifies for a pension without any reduction after the retirement age has been raised; this qualification being earned through, all things being equal, lower contribution rates. However, one cannot expect a higher rate of return as, unlike the law as it currently exists, bonuses of up to 12 percent (six percent per annum) will no longer apply. However, even in this case, changes in the rate of return are unlikely in the long term. But the transitional generation has to accept losses in returns too. According to calculations for those insured whose contribution history began at the age of 20 and who retire at 65, the nominal rate of return is for men and women of the birth cohort 1940 about 3.5 percent and about 4.0 percent respectively. Those born later must count on a rate of return that

is one percentage point lower.[2] Through the retirement age increase, the rate of return declines again by just under 0.2 percentage points. Those born earlier than the 1950 birth cohort enjoy a slight improvement in the rate of return based on higher pension adjustments. For them, the gradual raising of the statutory retirement age has almost no effect at present. They benefit from higher pension adjustments based on, all things being equal, a lower contribution rate. Those born in the mid-1960s suffer the greatest disadvantages (see figure 2).

Figure 2: Change in the implicit rate of return in the statutory pension insurance following the raising of the statutory retirement age to 67.



[2] For more detailed explanations on the calculation method, see the GSAC's 2004 Pension Insurance Report, (*Bundestags-Drucksache* 15/4498, 1.12.2004, no 104 ff.) The assumptions on the development of average wages and salaries until 2020 correspond to those that were employed in the 2002 Pension

30. In the long term, a new equilibrium is reached whereby the benefit volume, corresponding to the total pension payment period, in the statutory pension insurance shows a less pronounced increase, and as a consequence the contribution rate also has to be raised to a lesser extent. Ultimately, the raising of the statutory retirement age has an effect on the implicit rate of return that, in essence, does not differ from the sustainability factor or other measures aimed at limiting the general benefit level in the statutory pension insurance: the age cohorts that suffer the reduced benefits but do not enjoy the full advantage of lower contribution rates during their entire working life experience a disadvantage in the rate of return; however in the long term no permanent loss in the rate of return is to be anticipated. The benefit restrictions in the pension insurance are almost always connected with intergenerational distribution. During the transition phase, burdens occur that are seen alongside permanent advantages on the contribution side. Finally, it must also be taken into account that the relatively lower contribution rate always increases particular opportunities for an individual to make their own provision for old age.

31. The special regulation for those insured that can show at least 45 years of compulsory contributions from employment, self-employment, long-term care and child-raising periods causes the

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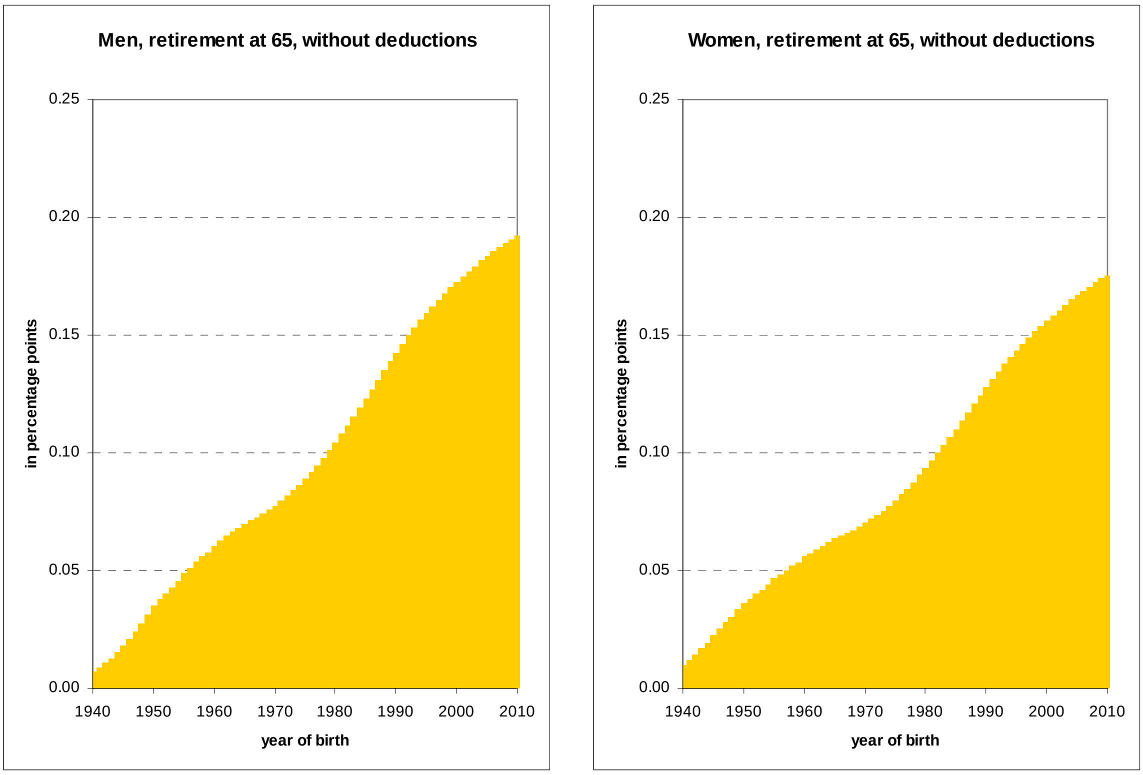
Insurance Report's projections. For the subsequent years a constant growth rate of 3 percent per annum was assumed.

moderating effect on the overall contribution rate increase to be less pronounced. This affects all contributors. However, those who retire at the age of 65 without deductions after 45 compulsory contribution years suffer no disadvantage in benefits compared with the current law. On the contrary, their pension turns out to be slightly higher since the lower contribution rate, all things being equal, moderates the pension adjustment to a lesser degree. As a consequence the rate of return turns out to be higher (see figure 3).

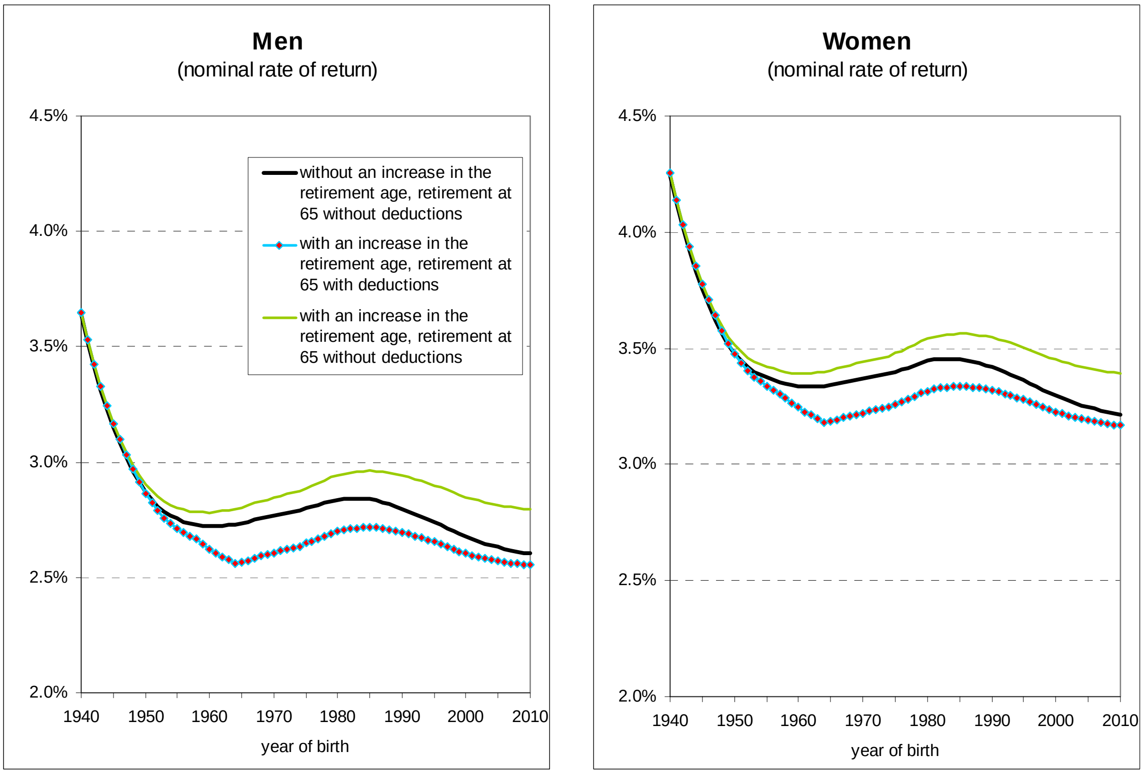
Figure 3: Change in the implicit rate of return in the statutory pension system for those insured with an exceptionally long contribution history.



32. In contrast, the insured who are not covered by this beneficial regulation must accept the highest possible benefit reduction but do not enjoy the advantage of a compensatory highest possible

contribution rate decrease. As a consequence, their implicit rate of return is permanently relatively lower. The beneficial regulation financed through contributions for those insured that can show 45 years of contributions also leads to an intra-generational distribution burden that falls on all other members of the pension insurance. Therefore for those insured under the special regulation, the rate of return nevertheless turns out to be permanently higher by 0.3 percentage points than for those who retire later or on a pension reduced by deductions (see figure 4).

Figure 4: Development of the implicit rates of return in the statutory pension insurance.



VII. Old-age pensions for those with an exceptionally long contribution history

33. Following the draft legislation on the Pension Insurance - Retirement Age Adjustment Act (*RV-Altersgrenzenanpassungsgesetz*), a new old-age pension for those with an exceptionally long contribution history is to be introduced alongside the gradual raising of the retirement age. According to this, those insured who can show at least 45 years of compulsory contributions can retire at 65 on a pension without deductions. Periods when contributions from employment and self-employment are paid, and periods of long-term care and

child-raising (*Kindererziehungszeiten*) count towards compulsory contribution years, as do child care years (*Kinderberücksichtigungszeiten*). Not accounted for are, among others, periods when, due to unemployment, contributions are paid by the Federal Employment Agency. Here the question arises to what extent excluding periods of unemployment in defining compulsory contribution periods represents an unconstitutional discrimination of such periods.

34. The deduction-free old-age pension for those insured with exceptionally long, contribution histories has a financial bearing on the statutory pension insurance. Thus, it is anticipated that, through this measure, in 2030 the savings effect and with it the moderating effect on the contribution rate will see an actual reduction of 0.2 percentage points and €2bn respectively. This corresponds to almost one fourth of the financial relief for the statutory pension insurance possible from raising the retirement age.

35. Therefore, an insured person with an exceptionally long contribution history receives a higher pension than an insured who has acquired the same amount of earning points in fewer than 45 contribution years and thus has to accept deductions. Consequently, now not only the level but also the duration of the contributions forms the basis for the pension amount. This means that the link between the level of contributions paid and the amount of pension received is weakened and thus the pension insurance

contribution's nature as a means of taxation is strengthened. Retiring on an old-age pension without deductions based on differences in the number of contribution years does not correspond to the participation equivalence principle. With the opportunity for those insured with an exceptionally long contribution history to retire on a pension without deductions, a new non-insured benefit is incorporated into the statutory pension insurance system which has to be financed by the contributors.

36. For those insured with an exceptionally long contribution history, the absence of deductions could act as a strong incentive to take the opportunity of retiring at 65. The GSAC raises objections on the grounds that this could contradict the law on equal treatment in view of previous judgments made by the Federal Constitutional Court based on Article 3 of the Constitutional Law.

37. In discussions about early retirement without any deductions, a fundamental problem not often taken into account is that the deductions calculated on actuarial principles that are applied to early retirement are not a punishment for retiring early but a compensation for the correspondingly longer pension period. The deductions should mean every pensioner – with average life expectancy and the same contribution payment – receives the same present pension value and this is independent of the particular age at which the insured takes retirement. Through this it is guaranteed that no group of insured faces any disadvantages that

others do not. Since the planned statutory regulation on old-age pensions without deductions for those insured with an exceptionally long contribution history abolishes this basic principle, this regulation results in problematic distributional effects. Whereas those insured with an uninterrupted work history benefit from this regulation**,** those insured whose work history liable for social insurance contributions is broken – even if not through their own fault – are disadvantaged in old age. For example, this applies to those insured who temporarily worked in jobs subject to insurance through a professional association or who were self-employed but not subject to the statutory pension insurance scheme. Furthermore, employees with a lower level of education, as they experience above average levels of interruption in employment life liable for social insurance contributions, and women are particularly affected. Based on an evaluation of the random sample *„Vollendete Versichertenleben 2004" (VVL 2004)*, the *Deutsche Rentenversicherung Bund* determined within a simulated calculation, that among those who retired in 2004 about one fifth showed at least 45 years of contributions earned through employment, child-raising periods and long-term care periods. Among men the proportion, at about 30 percent, is about three times higher than among women (about 11 percent). The difference between men and women is seen most noticeably in the old federal states (men: 31 percent, women: 8.5 percent), whereas the difference in the new federal states is relatively small (men: 25 percent, women: 21 percent).

38. The GSAC is critical of the regulation presented in the draft legislation on old-age pensions without deductions at the age of 65 for those with exceptionally long contribution histories. This regulation requires special social-political explanation. The explanation for the planned regulation in the draft legislation is that those insured with an exceptionally long working life regularly face extensive burdens. Although this conjuncture appears to be well founded in particular cases, the resultant regulation cannot be assessed so directly since the length of one's working life is not necessarily linked with extreme occupational burden.

VIII. Maintaining the retirement age with deductions for the long-term insured

39. The draft legislation stipulates that the retirement age for an old-age pension without deductions for the long-term insured is increased in increments from 65 to 67 from 2012 onwards – corresponding to the pension eligibility age. However, early retirement will still be possible. In the future, those with a long contribution history will still be able take early retirement from the age of 63. But an old-age pension that is taken early is still subject to a deduction of 0.3 percent per month. Therefore, from 2029 onwards the maximum pension deduction when retiring at 63 increases from 7.2 percent at present to 14.4 percent.

40. Pension deductions when retiring early are calculated on the basis of actuarial principles with the aim of burden neutrality. This approach ensures that the insured individuals’ chosen retirement date is neutral for the financial situation of the statutory pension insurance. In addition, an actuarial “fair” deduction has the effect of making the average rate of return of the pension insurance contributions paid about the same level, independent of the individual retirement age of the insured.

41. After weighing up the various effects, the GSAC welcomes the fact that the long-term insured are still able to retire early at the age of 63, with correspondingly higher deductions. With the incentive of ending working life in mind, an increase in the earliest possible retirement age is in principle desirable, but maintaining the earliest possible retirement age with deductions is in the long term largely cost neutral for the statutory pension insurance and allows an individual flexibility over when to take retirement. Giving up the previously set retirement age of 62 for the long-term insured who make early claims on an old-age pension serves primarily to avoid pre-financing costs that in 2015 would stand at €800m. However, maintaining this retirement age would have given the insured more flexibility over the start of their retirement – albeit with deductions.

IX. Increasing the reference age for pensions for reduced earnings capacity

42. According to the draft legislation for the Pension Insurance - Retirement Age Adjustment Act (*RV-Altersgrenzenanpassungsgesetz*), the retirement age for pensions for reduced earnings capacity is also to be raised by two years – from 63 to 65. Until 2023 the long-term insured with at least 35 compulsory contribution years from employment, self-employment, long-term care and child-raising periods until the child reaches the age of 10 can still draw a reduced earnings capacity pension from the age of 63 without deductions. From 2024 onwards, the qualifying period for a reduced earnings capacity pension without deductions is increased to 40 years. The qualifying periods are the same periods that are taken into account when calculating the old-age pension for the long-term insured.

43. The GSAC points out that these decisions on the introduction of the old-age pension for those with an exceptionally long contribution history and the regulations agreed with regard to reduced earnings capacity pensions are not precise. However, as regards their implementation, the increase in the reference age for claiming a reduced earnings capacity pension without deductions by two years is a consequent outcome of raising retirement ages. Based on the same considerations that were taken into account for old-age pensions for those with an exceptionally long contribution history, the GSAC views the exceptions linked to the compul-

sory contribution period for an early receipt of a reduced earnings capacity pension in a rather critical light.

X. Modifying the protection clause

44. The annual pension adjustment complies in principle with the development of gross wages and salaries per employed person. However, the statutory pension insurance's contribution income is based decisively on the development of gross wages and salaries liable for contributions, the values of which are only available after a time lag. The Pension Insurance - Sustainability Act (*RV-Nachhaltigkeitsgesetz*) stipulates that future pension adjustments are geared to this revenue. Because of this, the rate of change of the gross wages and salaries per employed person is taken as a basis for the pension adjustment and is later revised. Furthermore, an increase in the current pension value in the adjustment formula is avoided if the pension insurance's contribution rate is raised; the share of the gross wage paid into the additional old-age provision scheme (*Altersvorsorgeanteil*) that should represent the contribution to the Riester-Pension has increased or the ratio of equivalence pensioner to equivalence contributor has increased. However, a protection clause (§ 68 Abs. 6 SGB VI i. V. m. § 255e Abs. 5 SGB VI) prevents these moderating factors from reducing the current pension value.

45. Since the introduction of the sustainability factor in 2005, the level of pension payments would have been reduced without this

protection clause. According to the 2006 pension insurance report, the anticipated moderation in the increase of the current pension value cannot be put into effect until after 2008 because of the protection clause. Until 2008, the fact that the moderating factor is not in place amounts to about 3 percent in the old federal states and about 2 percent in the new federal states. This results in additional expenditure for the statutory pension insurance amounting to about €6bn in 2008.

46. Because of the protection clause, the relation assumed in previous projections between employees' salaries and the current pension value cannot be followed. The effect of the protection clause is to cause an increased basis effect on the pension level that – under the present regulation – cannot be caught up with and therefore necessitates a permanently higher contribution rate. Because of this the present version of the protection clause endangers the legally determined target of keeping the contribution rate at or under 20 percent until 2020 and 22 percent until 2030.

47. Therefore, the present protection clause will be modified. The draft legislation of the Pension Insurance - Retirement Age Adjustment Act (*RV-Altersgrenzenanpassungsgesetz*) is designed to catch up gradually from 2011 onwards with the curbs on the current pension value that have been omitted since 2005. For this, the positive adjustment rate of the current pension value calcu-

lated according to the legally determined regulations is to be halved.

48. From the GSAC’s point of view, catching up with the omitted curbs on the increase in the current pension value does serve to maintain the given contribution rate targets. However, it must be pointed out that with continuing weak wage growth, this can lead to a development of the pension payment amount that ever more questions the legitimacy and acceptance of this old-age security system. In particular, it has to be taken into account that the level of pension payments declined because of the transfer of the full long-term care insurance contribution on to pensioners and due to increased health insurance contributions and will decline again the following year.

XI. Raising the contribution rate of the statutory pension insurance to 19.9 percent from January 1, 2007

49. With the law on setting the contribution rates in the statutory pension insurance and the contributions and contribution subsidies in the agriculture pension scheme for 2007, the contribution rate in the universal pension insurance is to be raised to 19.9 percent from January 1, 2007. This increase is intended to keep the contribution rate below or at the legally set contribution rate target of 20 percent until 2009. However, to achieve the legally set minimum sustainability reserve of 0.2 of monthly expenditure at

the end of 2007, an increase of the contribution rate by 0.2 percent to 19.7 percent would have been sufficient.

50. If the contribution rate for 2007 were to be set at 19.7 percent, the contribution rate in 2008 would, as a result, have to be raised to 20.1 percent, which would miss the legally set contribution rate target. Because of the adjustment rule (*Verstetigungsregelung*) the contribution rate is only then allowed to be lowered if the sustainability reserve exceeds the value of 1.5 of monthly expenditure. Therefore, the increase necessary in 2008 to 20.1 percent would not be restricted to 2008 but continue until 2010. But increasing the contribution rate to 19.9 percent in 2007 makes it possible to keep this rate below 20 percent in 2008 and 2009 without any additional financial requirements.

51. Taking into account the stabilization of the contribution rate linked in the medium term with the increase in the contribution rate, the GSAC welcomes this step if measures to limit expenditure that have a short-term affect are to be prevented. Thus, the possible contribution rate stability in the statutory pension insurance serves, in the opinion of the GSAC, as a way of responding to an ongoing public discussion about the financial situation in the statutory pension insurance.

XII. Statement on the medium-range projections to 2010

52. The assumptions made from October 20, 2006 form the basis of the medium-range projections for the years 2006 to 2010 in the

2006 pension insurance report. The assumptions for the middle-variant of the long-term model calculation refer to economic and demographic basic assumptions made by the “Commission for the Sustainable Financing of the Social Security Systems”. The projection for demographic development was updated in response to the assumptions made by the Federal Statistics Office’s 11th coordinated population projection of November 2006.

53. Furthermore, the calculations took into account the law passed on raising the normal pension age for demographic development and to strengthen the financial basis of the statutory pension insurance (*RV-Altersgrenzenanpassungsgesetz*) and the law passed on fixing the contribution rate in the statutory pension insurance and the contribution rate and contribution bonuses in the agricultural pension scheme for 2007.

54. The 2006 pension insurance report has taken into account a growth in GDP for 2007 of about 1.4 percent. This assumption falls short of the growth of 1.8 percent estimated by the German Council of Economic Experts (SVR). In the medium term an average growth rate of 1.6 percent is assumed. The number of employees was assumed to rise in 2007 by about 0.57 percent and in the medium term by 0.37 percent. Again, the assumptions for 2007 fall short of the forecast made by the SVR. The medium-term value was reduced from 0.5 percent in the previous report to 0.37 percent.

55. As far as per capita gross wages and salaries are concerned, 2007 saw a 0.9 percent rise in comparison to the previous year. Moreover the increase was below the 1.2 percent value forecast by the SVR. For the medium term, the projected annual rise in the previous report has been lowered from 1.5 percent to 1.2 percent. In terms of the wage development in regards to contribution income considered in the pension insurance report, the expected change in gross wages and salaries is reduced by about 0.4 percentage points at a time until the end of 2008. This is based on the fact that in recent years, due to the remuneration conversion of earnings that are exempt from social security contributions within the framework of occupational pensions, income liable for contributions has risen at a lower rate than gross wages and incomes. If the wage and salary sum liable for compulsory contributions should grow more strongly than assumed in the pension insurance report, the financial situation of the statutory pension insurance will be further eased. The contribution income from compulsory contributions to the statutory pension insurance will grow by around €150m, when the wage and salary sum liable for compulsory contributions grows by 0.10 of a percentage point.

56. The 2006 pension insurance report assumes a decrease in the number of registered unemployed to an average figure of 4.34m in 2007. This is about 70,000 more unemployed than the SVR forecasts. The pension insurance report also assumes that in 2007 the number of jobs liable for social insurance contribu-

tions will grow by 0.66 percent in the old federal states and 0.42 percent in the new federal states. In the medium term, in comparison with the 2005 pension insurance report, the annual growth rate in the old federal states will be reduced by about 0.6 percent to about 0.45 percent. If the development of jobs liable for social security contributions turns out to be more positive than assumed, the statutory pension insurance would earn for every 100,000 additional jobs liable for compulsory contributions about €450m in additional income.

57. The law on strengthening competition conditions within the statutory health insurance system that was passed by the cabinet in October 2006 (*GKV-Wettbewerbsstärkungsgesetz)* also has an effect on the finances of the statutory pension insurance. Against the background of this law, it was assumed in the model calculations that the equally financed contribution rate to the statutory health insurance would permanently rise by 0.5 percentage points. Moreover, for 2007 a temporary 0.3 percentage point increase was assumed for the equally financed contribution rate, which is necessary for the statutory health insurance scheme's debt write-off. An increase in the general contribution rate of the health insurance scheme for pensioners by 0.1 percentage points leads to the statutory pension insurance suffering an additional financial expense of about €100m.

58. The statutory pension insurance will end 2006 with a surplus predicted to be just under €6bn. This positive result is based on the welcome economic development, in particular on bringing forward social insurance contributions that could lead to the receipt of one-off additional contributions of €10.5bn. Due to the one-off additional contribution income in 2006, the sustainability reserve is projected to reach €8.2bn. Through the expected reduction in the sustainability reserve from 0.52 of monthly expenditure in 2006, to 0.36 of monthly expenditure in 2007 and 0.27 of monthly expenditure in 2008 respectively, the contribution rate can, in accordance with the statutory guidelines, be kept to 19.9 percent in the period. Up until 2010 the sustainability reserve is again built up to 0.47 of one month’s expenditure through a 19.9 percent contribution rate.

59. In accordance with the results of the medium-term calculations in 2007 and 2008 — as in the years from 2004 to 2006 — no positive pension adjustment can be reached. Indeed in this year the decisive gross income increases, but otherwise the adjustment moderating effect of the contribution rate change, the “Riester-Steps” and the sustainability factor prevent an increase in the actual pension value. However, a cut in the real pension value by the factors named above is prevented only by the protection clause.

60. The GSAC particularly welcomes the fact that the medium-term economic basic assumptions for the 2006 pension insurance report are more cautious than in previous years. Thus all the assumptions for 2007 are below the estimates of the SVR. For the medium-term assumptions, the values are, compared to the previous report, reduced. The medium-term projection results set out are likely to give financial development in the pension insurance that is below the previous limit. The calculations show that the financial position of the statutory pension insurance has clearly improved and in the medium term continues to be mostly secure.

61. The GSAC points out that from January 1, 2007, because of the “Act to Change the Social Code, Part II and other laws” (*Gesetz zur Änderung des Zweiten Buches Sozialgesetzbuch und anderer Gesetze*), a substantial reduction of the monthly contribution limit for recipients of unemployment benefit II from €400 to €205 will come into effect. Through this, the pension insurance’s annual contribution revenues will be reduced by about €2bn. Without this reduction, the contribution rate to the statutory pension insurance could, as shown in the medium-term forecast, be lower by about 0.2 percentage points.

62. The planned changes to the competition strengthening laws could, in the GSAC’s view, lead to a change in the liquidity of the pension insurance. Currently the risk structure compensation across the different health insurance funds is taken on by the

statutory pension insurance. The compensation payments between the health insurance funds are carried out through this risk structure compensation in as far as no offsetting with the pension insurance contributions may take place**.** When the law aimed at strengthening the competition conditions comes into force after January 2009, this will no longer be possible. In the view of the GSAC**,** a new regulation setting the due date for contributions to the pensioners’ health insurance scheme must then be established in order that the new regulation of the risk structure compensation does not lead to a worse liquidity situation for the pension insurance.

XIII. Statement on the 15-year projections until 2020

63. The presentation of the financial situation in the long term until 2020 follows the same methodology as in previous years. Three assumptions regarding wage development are linked to three assumptions regarding employment development giving nine variants in total. These long-term projections serve as a means to test the influence of changes in the various assumptions made about future economic trends. In effect, they clarify how the finances of the pension insurance system react within particular economic and demographic parameters. In this context the GSAC recognises that these long-term projected calculations are not to be understood as prognoses for future development.

64. The long-term assumptions for wage development in the old federal states take for the average annual growth rate in the different variants 1.5 percent, 2.5 percent and 3.5 percent. Thus it follows that constant wage increase is no longer assumed, rather that the growth rates of the wage increase rise continually from 2010 to 2020. In the middle variant, the growth rate rises from 2 percent to 3 percent and results in an average annual growth rate of 2.5 percent. For the new federal states, it is assumed that the wage level of the old federal states will be reached by 2030. For this long-term period, assuming a wage increase of 3 percent is compatible with the findings of numerous national and international studies.

65. Although the long-range calculations are to be understood as model calculations and not prognoses, against the background of a legally defined contribution target of 20 percent and a pension target level of 46 percent in 2020 they have particular significance.

66. If the contribution rate in the middle variant for the calculation until 2020 exceeds the 20-percent limit, the federal government is bound by law to submit specific proposals to the legislative bodies to ensure this can be prevented. In keeping to the contribution target of the crucial middle variants of the model calculations, a contribution target of 20 percent will, according to the 2006 pension insurance report, be adhered to exactly. The corresponding

middle variant for 2019 of a contribution rate of 19.5 percent corresponds approximately to the value set out in the 2005 pension insurance report of 19.4 percent. In three variants of the model calculations, the contribution target will, however, be missed in 2020. In total, the 20-percent limit will be, at least temporarily, exceeded in four of the nine variants, and in two variants the targets will be met exactly. It is striking that the value of contribution rates in the middle variants from 2019 to 2020 show leaps from 0.2 to 0.7 contribution points – depending on what employment development one looks at. This can be traced back to the fact that when maintaining a contribution rate dependent on the sustainability reserve that existed at the end of 2019, the sustainability reserve in the model calculations with the middle wage variant falls to a varying extent short of 0.2 of monthly expenditure by this time, and thus contribution rate increases are necessary.

67. In case the gross pension level in the statutory pension insurance falls below a value of 46 percent in the calculations, the federal government is bound by law to submit specific proposals to the legislative bodies to ensure this can be prevented. In the four relevant variants here there will be no shortfall in the legally determined gross pension level. For 2020 there will be a gross pension level of 46.6 percent.

Berlin, November 23, 2006.

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