Report of the German Social Advisory Council on the Federal Government's 2002 Pension Insurance Report

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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 2002 Pension Insurance Report. This statement addresses firstly those parts of the report that refer to the future development, i.e. projections over the medium-term and the model calculations for the next 15-year period. 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 2002 draft report on pension insurance. In addition, the GSAC was able to approach the Federal Ministry of Health and Social Security for additional information and explanation where necessary.
2. The massive decline in economic development and the consequent poor contribution income has led to further legislative measures being needed to be taken as regards the Statutory Pension Insurance Scheme. The GSAC therefore comments on the proposed measures to slow the increase in the contribution rate, by means of the introduction of a corridor for the target value of the fluctuation reserve from 0.5 to 0.7 of one month's expenditure as well as raising the contribution assessment limit for the statutory pension insurance.
3. The 2002 Pension Insurance Report describes – as every year – the current and future financial position of the Statutory Pension Insurance Scheme. It includes an outline of predicted financial trends for the next four calendar years on the basis of the Federal Government's current assessment of medium-term economic trends as well as on long-term model calculations. The latter comprise the financial development to the year 2016 using nine model calculations

generated through taking three assumptions regarding wage trends combined with three employment scenarios. This shows not only the income and expenditure of the Pension Insurance Scheme but also each of the necessary contribution rates (in each year) and – as in the past year – the development of the standard pension level in the states of the former Federal Republic of Germany[1] following the middle variant.

4. These projections are made on the basis of the law. They take into account measures having a financial bearing on the Pension Insurance Scheme that have either already been passed in cabinet or are still in the legislative process and are about to come into force. This applies to the planned measures in the draft bill to guarantee contribution rates in the Statutory Health Insurance Scheme and in the Statutory Pension Insurance Scheme and to planned measures regarding the fluctuation reserve, the contribution assessment limits and the contribution rate as well as the implementation of recommendations made by the Hartz-commission found in the framework of the draft bills concerning modern services in the labour market.
5. Because of the financial integration of the German Statutory Pension Scheme for both former East and West Germany the results are described jointly for the pension insurance scheme in both parts of the Federal Republic of Germany. However, the medium-term calculations regarding the income and expenditure for east and west federal states are described – as in the report of the previous year – separately.

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[1] Here the federal states of the former Federal Republic of Germany are referred to as "former West Germany"; the federal states of the former German Democratic Republic are referred to as "former East Germany".

II. Statement on the medium-range projections until 2006 of the 2002 Pension Insurance Report

6. The assumptions of the interministerial "National Economic Projections" team made from end of October 2002 for the following year as well as of those of participating federal ministries also made from end of October 2002 for the years 2004 to 2006 form the basis of these projections. On the basis of these assumptions and the aforementioned statutory duty and in the view of the worsening economic outlook and recognisable financial risks, the contribution rate in 2003 has been fixed at 19.5 per cent. Without the measures in the law guaranteeing contribution rates in the Statutory Health Insurance Scheme and the Statutory Pension Insurance Scheme, the contribution rate for 2003 would have been fixed at 19.9 per cent. For the following period it is calculated at 19.4 per cent (2004), 19.2 per cent (2005) and 19.1 per cent (2006). The obvious deterioration in comparison with the corresponding values in the Pension Insurance Report of the previous year (2003 = 19.1 per cent, 2004 = 19.0 per cent, 2005 = 19.0 per cent) is mainly due to slightly lower expectations regarding basic economic assumptions. In the current climate these are still over optimistic. In particular, the underlying expectation that a 1 per cent increase in economic growth would lead to an increase in employment is not borne out by past experience. In 2002 in particular the fall in employment and the increase in the number of unemployed as well as the cyclical reduction in sales tax volume have led to a reduction in the income of the Pension Insurance Scheme. Given a fixed benefit level, raising the contribution rate in 2003 was necessary. Against this background, the GSAC is critical of the assumptions made about wage

development (+2.5 per cent) and a reduction in employment of 0.09 per cent in the following year. The GSAC made a similar criticism last year.

7. The planned further reduction of the target value for the fluctuation reserve as well as uncertainty about the increase in the contribution rate to the Statutory Health Insurance Scheme and about further wage development when set against the background of the new right to remuneration conversion as part of the reform of occupational pension provision add to the financial risks faced by the Statutory Pension Insurance Scheme. A year ago, the target value for the fluctuation reserve was estimated at 0.73 of one month's expenditure for the end of the year 2002, using the German Council of Economic Experts' projections for economic development as a basis. In fact, at present the value is only 0.63 per cent of one month's expenditure. This fact highlights the risks involved in using too low a target value for the fluctuation reserve combined with making too optimistic an assumption for economic development.
8. In regard to the development of current pension values in former East and West Germany, the report takes as its premise a greater, albeit incremental convergence in the mid-term period until 2006. Therefore, the ratio of the current pension values further converges. At present it is not possible to set a time frame within which both current pension values are identical because the pensions reflect different wage developments in former East and West Germany. However, it must be noted that the financial situation of the Pension Insurance Scheme is in effect determined by trends in former East Germany. There, the yearly expenditure is set to exceed income by between 13.2 and 14.2 bn Euro in the years 2002 to 2006. Of

fundamental significance for this outcome are developments in employment levels since 1990: while the number of those employed stood at 8.6 million in 1990, only 5.6 million people will be employed in 2002.

If in time a faster convergence of current pension values between East and West is called for, it would entail not only a disassociation from actual wage developments but also considerable additional expenditure possibly over an extended period of time. For both these reasons it would, in the opinion of the GSAC, be better to leave the present situation as it is.

9. This is also indicated by the fact that average pension payments for those with a reduced earning capacity and old-age pensions in former East Germany are 103.6 per cent for men and 134.7 per cent for women as against the reference value in former West Germany. The determining factor for this imbalance is foremost an on average longer insurance period for pensioners in the former East Germany. According to the evaluation of 'The Federation of the German Pension Institutes' ("Verband deutscher Rentenversicherungsträger"), the average insurance period in the states of former West Germany was 40.0 years for men and 25.8 years for women, in contrast in East Germany it was 45.3 years for men and 35.8 years for women.

   However, when evaluating a particular income position one must allow for the fact that until recently occupational pensions have played only a minor role in former East Germany, thus levels of private wealth – in as far as data is available – are lower in the East than in the West.

10. In the medium-term calculations the annual pensions adjustment made on July, 1st of each year are also included. These are determined according to the pension adjustment formula of the 2001 pension reform – the gross wage trend modified by the change in the contribution rate and also by the notional contribution towards private old-age security – and guarantees that pensioners enjoy economic growth as reflected in wage trends. Because of a low average rise in real wages between 2001 and 2002, the pension adjustment for 2003 will be comparably low: in former West Germany it is likely to stay below one per cent (in former East Germany just over one percent). This is in contrast to about two per cent in both preceding years (2002: 2.16 per cent in the West and 2.89 per cent in the East; 2001: 1.91 per cent in the West and 2.11 in the East).
11. The projections also allow for the fact that in 2003 the fluctuation reserve will be cut to a corridor of between 0.5 and 0.7 of one month's expenditure. In the future the Contribution Rate Stability Act ("Beitragssatzsicherungsgesetz") will allow this reduction. The GSAC comments on this later in its report.

III. Statement on the 15-year projections of the 2002 Pension Insurance Report

12. The presentation of the long-term financial trends until the year 2016 uses the same methodology as in previous years. Again nine variants taking wage rises of two, three and four per cent are computed, whereby one scenario with a lower and a higher employment trend is calculated. The calculations show how the

pension system reacts to different wage and employment assumptions in the medium and long term.

13. In the version with the lower employment trend it is assumed that for the states of former West Germany the number of workers and employees rises by 1.17 million until 2016 (compare Overview B 13 of the 2002 Pension Insurance Report). The corresponding figures for the middle and higher employment trend are 1.58 and 2.00 million respectively. In comparison with the Pension Insurance Report of the previous year, in all versions the assumed values are lower. For wage trends, growth rates of two, three and four per cent of the average gross wage are assumed. In a comparison between the long-term and medium-term assumptions, the latter (see II) fall at the lower end of the chosen assumed corridor. In the future one must therefore consider whether the model assumptions for the long-term projections should be corrected downwards.
14. For the states of former East Germany – as in the Pension Insurance Report of the previous year – three employment trends are also determined. In the lower variant a long-term decline in employment until 2016 of about 100,000 is used for calculations, in the middle variant a fall of 250,000 and in the higher variant 400,000. These figures are also lower than in the Pension Insurance Report of the previous year. The model variants for former West Germany are linked to the corresponding variants for former East Germany.
15. Here it must be pointed out that limited comparisons can be made between the previous year's calculations and the calculations of the current report due to different assumptions about the economy being used. Moreover, as the Contribution Rate Stability Act ("Beitragssatzsicherungsgesetz") was not yet in force in 2002, its

influence on the financial position of the pensions' system were naturally absent.

16. The assumed employment trend presumes that the current trend for the participation of women in the labour market will continue to rise. For the financial status of the pension system, this growth in employment caused by the increased participation in the labour market has a strong beneficial effect. (This is because the Federal Employment Office pays a lower contribution rates for unemployed workers. Growth in employment due to increased participation rates means that full contributions are paid into the system by workers who before entering the labour market did not pay contributions at all). These assumptions are possible real scenarios, though one must take into account the usual uncertainties that go with any long-term calculation. In this context one must take into account the fact that higher labour force participation rates for women mean higher part-time ratios, which generally entail lower wage rises.
17. To keep the contribution rate below 20 per cent until 2020 was and remains the stated aim of the Federal government. With the pension reform of 2001, the unfunded Statutory Pension System was supplemented by a capital-funded pillar. This innovation and the modification of the pension adjustment formula set the course for the future. The task of the commission for "achieving financial sustainability in the Social Security systems" – appointed by federal minister Schmidt on November 21, 2002 – is to audit the systems of health- and long-term care insurance as well as the pension insurance and to produce proposals to ensure that they are both financially sustainable and organisationally robust in the future. As regards the statutory pension insurance scheme, the commission will audit the effects of the 2001 pension reform and will address how to continue

the policy of expanding its capital-funded supplementary systems. In this context, the commission is also to review the question of the extent to which the fundamental paradigm shift towards a stronger income-orientation of expenditure that was begun in the 2001 pension reform, will continue.

IV. Principles regarding the long-term projections

18. The long-term projections serve as a means to test the influence of changes in the various assumptions made about future economic and demographic trends. In effect, they clarify how the statutory pension system reacts (particularly in terms of contribution rate, pension level, federal subsidy) on the particular economic and demographic parameters (earned income, labour participation rate, etc.).
19. The GSAC has underlined this on several occasions and has pointed out that the model calculations in the Pension Insurance Report by the Federal Government for the 15-year-period are not prognoses. Within limits the five-year projections, which also form the basis for determining the contribution rate in the coming year, could serve this function. Long-term model calculations can only assess the effect of different measures and/or possible economic trends. And therefore it is inadvisable to take a particular result from the nine variants of the 15-year-model calculations as the relevant one or the "most likely" outcome. The combined assumptions regarding the average gross wage trend and the employment rate are unlikely to encompass all possible developments. In particular a combination of unfavourable assumptions (continuous wage growth rate of 2 per cent and an increase in employment of just 1.2. million until 2016 in former

West Germany) implies that there is a level below which the economic situation cannot fall whereas in fact there is no such limit.

20. Although the results of the long-term model calculations can only be illustrations, it is none the less important to demonstrate how sensitive the results are in regard to changes in contribution rates against changes in the underlying assumptions. In the 2002 Pension Insurance Report it is shown how the contribution rates, necessary to maintain the target value of the reserve fund in a corridor between 0.5 and 0.7 of one month's expenditure, change according to which assumption is made for growth rates of employment and wages.
21. A change in the wage trend – as well as an increase or a decrease about one percentage point – causes a "base effect" on the contribution rate of no more than 0.1 of contribution rate points. The effect of a deviation in the underlying wage trend on the projections made concerning the cycle of the contribution rate would therefore be insignificant. Deviations in the assumed employment growth rate have a slightly stronger influence on the contribution rate. Here the base effect is up to 0.4 percentage points. In total the difference between the most and least favourable combination of assumptions accounts for 0.6 percentage points.
22. For the statutory health insurance contribution rate, the federal government assumes a rise to 14.2 per cent both for former East and West Germany. The likelihood of this assumption depends above all on the results of the forthcoming health insurance reform. Because of the modified wage adjustment for pensions, changes in the contribution rates of long-term care- and health-insurance do not have a direct effect on pension adjustments. Pensioners' contributions to both these classes of social security insurance come from their gross pensions. But a change in the contribution rates for

long-term care- and health-insurance affects the subsidy paid by the Pension Insurance Institutes to these classes of insurance. This subsidy corresponds to the share of contribution paid by the employer. A rise in the contribution rates in this area means that the amount paid out as pension decreases while the subsidy paid by the pension insurance to the health- and care insurance increases. As a result, an increase in the contribution rates to the health- and care-insurance of about one percentage point through a rise in subsidies leads to an increase in the contribution rate to the statutory pension insurance of about 0.1 contribution rate points. A marked rise in the contribution rates of the statutory health insurance scheme could – in the long term – affect the Federal government's targets for the contribution rate in the statutory pension insurance.

23. The GSAC points out that the 15-year model calculations do not cover the period in which the influence of the demographic burden will be at its strongest. Given current legislation, the moderate growth in the contribution rates stated in the model calculations is likely to become stronger outside this time frame.

V. Planned consolidation measures

24. Because of the introduction of a corridor from 0.5 to 0.7 of one month's expenditure for the fluctuation reserve as well as the additional revenue from raising the contribution assessment limit for the pension insurance scheme for white and blue collar employees to roughly double the current average income, an additional financial leeway of up to 4.7 bn Euros (through the adjustment of the reserve fund) and about 1bn Euros (due to raising of the contribution assessment limit) have opened up. This suggests that it will be

possible to limit the rise in the 2003 contribution rate to 0.4 percentage points. Without these two measures, the contribution rate would have to be increased to 19.9 per cent in 2003. With a contribution rate of 19.5 per cent, a reserve fund of 10.4bn Euros corresponding to 0.66 of one month's expenditure is predicted.

a. Lowering the target value of the fluctuation reserves

25. To balance short term income fluctuations, which are unavoidable in the yearly cycle, is nowadays the only function attributed to the financial "reserve" of the pension system – the so-called fluctuation reserve. The financial reserves in the pension system are the highest at the end of the year due to one-off payments (Christmas bonuses) then decrease continuously during the following year to reach a low point in October. The 20th Pension Adjustment Act of June 27, 1977, stipulated that the reserve fund must be invested in liquid form in instruments whose maturity, remaining period to maturity, or notice period do not exceed 12 months.

26. Past experience has shown that a target value for the fluctuation reserve equal to 80 per cent of one month's expenditure – as required by law – is not necessary to ensure the liquidity of the pension insurance institutes at any time. To some extent in the 1980s and particularly in the 1990s, the financial reserves of the pension system fell far below one month's expenditure by the end of the year without putting the liquidity of the pension insurance institutes at risk. The decisive factor was – apart from the level of the fluctuation reserve as expressed in monthly expenditure – the available liquidity which – measured by the size of the reserve fund – increased considerably after 1977 when long-term capital investments were no longer

permitted and revenue from long-term investments had to be invested in liquid form. Thus, the situation has been reached whereby the majority of the pension systems' financial assets are invested in liquid form. The GSAC explained this in some detail in its 2001 report.

27. Regulating the monthly payment of federal subsidies will further secure the statutory pension insurance scheme's liquidity. The opportunity in the short-term to allocate more funds from the regular monthly federal subsidy payments in order to avoid payment bottlenecks has already been set out in the current budget plan. The GSAC sees such an aim, as expressed in the explanation of the draft bill for the Contribution Rate Stability Act ("Beitragssatzsicherungsgesetz") – about introducing such a measure to secure liquidity into federal budget legislation – as appropriate. And this measure has now been put into effect.

    Moreover, the Pension Reform Act 1992 stipulates that the Federal Government has a "guarantee function" requiring it to ensure the liquidity of the statutory pension insurance scheme. This means that the government can provide capital for loan purposes if the fluctuation reserve is insufficient to fulfil payment obligations. Such funds must be repaid by the pension insurance institutes in the following year. And these commitments would be included when calculating the contribution rate for that year.

28. With every lowering of the target value, the "security function" of the fluctuation reserve diminishes in importance. This has become even more marked as the financial risks to the pension insurance scheme have increased. A fall in the fluctuation reserve to 50 per

cent would mean disposable liquidity of less than 20 per cent of one month's expenditure in October. Liquidity problems would be unavoidable with even a slight deviation from the projected path. It must also be taken into account that any discussion of liquidity constraints adds to public anxiety, particularly among pensioners, and could weaken confidence in the financial solidity of the pension insurance scheme. And therefore an adequate minimum level for the fluctuation reserves is necessary. Against this background, the GSAC does not regard any further lowering of the target value as a viable option. In addition, conditions suggest the need for a cautious assessment of the future economic climate and therefore a realistic assessment of the contribution rate for the following year.

b. Raising the contribution assessment limit

29. An increase in the contribution assessment limit results in further stability of the contribution rate. The contribution assessment limit for the Statutory Pension Insurance adjusted (apart from rounding rules) to gross wage trends has in previous decades meant that the maximum amount from which the employees' contributions are calculated equalled about 1.8 of average earnings in the corresponding year. As average earnings for Statutory Pension Insurance purposes can at present only be estimated, and given that the actual value calculated in retrospect usually differs, the contribution assessment limit fluctuated between 1,7 and 1,9 of average earnings in the given year. In the present legislative process it has been decided to raise the contribution assessment limit to about double the average earnings.

    This is done by setting the contribution assessment limits for 2003 for former West Germany. To this end, the contribution assessment

limit's base values for 2002 are first projected forward according to the adjustment rule in section 159, Social Code, Part VI by the variation rate of the gross wage and salary sum per average employee for the year 2001 amounting to 1.77 per cent. The initial values for the 2003 contribution assessment limit calculated by this method are multiplied by the ratio of 2.0 to 1.8, then rounded up to the next figure divisible by 600 that gives a whole number. As a result, the 2003 contribution assessment limit (West) for the pension insurance scheme for white- and blue-collar employees is 61,200 Euros per annum/ 5,100 Euros per month, the contribution assessment limit (West) for the miners' pension insurance is 75,000 Euros per annum/ 6,250 Euros per month.

Contribution assessment limits for former East Germany are determined according to the rule in section 275a, Social Code, Part VI. The unrounded contribution assessment limits for former West Germany in 2003 (mentioned above) are divided by the preliminary value as given in Appendix 10, Social Code, Part IV for the year 2003 and then rounded up to the next figure that can be divided by 600 to leave a whole number. As a result, the 2003 contribution assessment limit (East) for the pension insurance scheme for wage and salary earners is 51,000 Euros per annum/ 4,250 Euros per month, the contribution assessment limit (East) in the miners' pension insurance is 63,000 Euros per annum/ 5,250 Euros per month.

30. For future years the contribution assessment limits are calculated as above – starting each time with the new unrounded value. By this method, the pension insurance's contribution assessment limits for

white- and blue-collar employees are raised to approximately double the average wage.

About 1.5 million of those insured are affected by this reorganisation, and an additional contribution income of about 1bn Euros per annum can be expected. This corresponds to approximately 0.1 contribution rate points. The lowering effect in the contribution rate, however, does not last as one must take into account higher pension payments, though not in the short term. In the medium and long term, there will be a return to the previous status quo albeit at a higher level at a time when the pension insurance is likely to be under considerable pressure because of demographic trends. In addition, in the present difficult economic situation both employees and employers are not only burdened by a rise in the contribution rate from 19.1 to 19.5 per cent but also by the effect of the rise in the contribution assessment limit.

31. Members of the GSAC disagree in their assessments of the effect of raising the contribution assessment limit: Some GSAC members see the measure as contrary to the intentions of the 2001 pension reform, which saw its prime aim as a gradual limiting of the scheme's pay-as-you-go pension system in favour of capital-funded old-age security in the second and third pillar. But, the steep rise in the contribution assessment limit broadens coverage of the statutory pension insurance and negatively affects the leeway for the capital-funded old-age provisions. Moreover, these GSAC members see this measure as only adding to the demographic trend's effect on the pension system as it will generate additional pension entitlements to be paid when the demographic burden on the pension insurance scheme will be at its heaviest, and thus put extra strain on a difficult long-term difficult financial situation. The agreed discretionary rise

in the contribution assessment limit, which goes far beyond the annual adjustment in the contribution assessment limit, could include a reduction of the employers' subsidy of the occupational old-age provisions which could result in reduced entitlements to occupational pensions. Against this background this part of the GSAC suggests freezing the contribution assessment limit at the 2003 level until the original level of 1.8 of average earnings is reached again.

32. Other members of the GSAC consider the agreed measures in the Contribution Rate Stability Act ("Beitragssatzsicherungsgesetz") overall an acceptable solution as regards the balancing distribution of costs. In particular these members of the advisory council refer to the increased burden on pensioners resulting from the downturn in the pension adjustment in 2004 due to the rising contribution rate in 2003. In the opinion of these members of the advisory council one must take into account the fact that both the employees' and the employers' contribution to the pension insurance scheme has the effect of lowering the pension adjustment. Therefore these members of the advisory council justify raising the contribution assessment limit as regards the wealth distribution since the relatively better of insured contribute more to (finance) the pension insurance scheme. Those insured whose income puts them in a category close to the contribution assessment limit normally have considerable additional entitlements to personal or occupational old-age provisions that are – according to these GSAC members – not greatly affected by this measure. Furthermore, government aid for private old-age provisions acts to compensate the declining safety net of the first pillar in the long term, which particularly affects the insured on lower incomes. Therefore this measure does not contradict 2001 reform's

fundamental aim of strengthening the capital-funded old-age provision.

VI. Reform of the organisation of the pension insurance scheme

33. The reform of the organisation of the pension insurance scheme, which has already partially begun, is likely to be subject to further legislation in the 2002-2006 legislative period. The parliamentary audit committee is due to address this next spring. It has asked what until 2002 was the Federal Ministry of Labour and Social Affairs to present a further report on the progress of the reorganisation.
34. The agreement between the ruling SPD/Green Party coalition underlines the importance of improving the effectiveness and efficiency of the pension insurance scheme by means of a comprehensive reform that will simplify its administration. At the same time, any reform should consider the concerns of employees and the reform should be undertaken in a socially acceptable way. The GSAC is in agreement with shortcomings identified by the "Organisation Report" compiled by consultants Roland Berger and the Federal Audit Court's report (both drew attention to a proliferation of institutions, their multiple duties and corresponding coordination problems). The GSAC likewise sees the need for an organisational reform. Controlling the pension insurance scheme at federal level should remain a principle aim, as only this guarantees uniformity and equality across the whole scheme.
35. The "Reorganisation of the statutory pension insurance" working group, set up following a decision by the budget committee and the audit committee of the Lower House of German Parliament on June 16th, 1999, under the control of the then Federal Ministry of

Labour, dealt mainly with drafting a reorganisation plan that would be acceptable to all interested parties. As well as the Federal Audit Court and the Federal Ministry of Finance, the working group included representatives of the federal states of Bavaria, North Rhine-Westphalia, Schleswig-Holstein, Saxony, Berlin and Baden-Württemberg as well as three representatives from 'The Federation of the German Pension Institutes' (VDR), from 'The Federal Insurance Fund for Salaried Employees' (BfA) and the regional pension insurance funds for Rheinprovinz, Upper Bavaria and Westphalia. Initially, the group's task was mainly to arbitrate between the four, very different organisational models under discussion:

- A model developed by the Federal Audit Court on the basis of report from Roland Berger to replace the Federation of the German Pension Institutes with a central "pension council" and to reduce regional pension insurance funds to six; to transfer the main part of the Federal Insurance Fund for Salaried Employees to the regional pension insurance funds as well as transferring employees insured under the Berlin and Baden-Württemberg regional pension insurance funds to the Federal Insurance Fund for Salaried Employees.
- The Federal Insurance Fund for Salaried Employees model of a central Federal Agency for Pension Insurance and six dependant regional processing offices.
- The "Länder-Model" taken from the draft of a Competence Adjustment Act ("Zuständigkeitsänderungsgesetz") introduced in the 14th legislative period by the Upper House of the German Parliament: this envisages the successive transfer of the majority of insured employees to regional pension insurance funds.

- One based on discussions of the social partners presented in May 1999 that divides tasks between the federal level (strategic tasks and functions across the sections, as well as certain operative tasks) and the regional level (main part of processing operations). The federal level would have the authority to make binding decisions on regional funds.

36. The working group agreed that given the contradictory interests of its members only a solution that had consensus of all would be acceptable. It was therefore decided to choose the "social partners model" as a starting point for further consultation as it already aims to balance regional against federal positions. On the basis of the social partners' paper, an outline paper was produced that stated which tasks would be performed at which level.
During the bilateral discussions with the states' and pension insurance' representatives that began in mid 2000 to decide unresolved questions about the consensus model, there was an initial convergence of opinion. Important questions such as the future constitution of the organisation, details about how tasks would be divided between federal and regional level as well as the reduction in the number of funds were left open. Given the structural reform of the pension insurance scheme and as yet unresolved constitutional questions (regarding whether the Federal level can control the regional level), further negotiations on the organisational reform were put on hold.

37. In the meantime there has been a tendency towards co-operation and amalgamation among regional insurance funds. After the merger of the regional pension insurance funds of Baden and Württemberg

took place, the regional pension insurance funds for Hamburg, Schleswig-Holstein and Mecklenburg-Western Pomerania agreed on a “Co-operation North”, which is to be developed into a merged institution by 2005. Legislation for the merger of the regional pension insurance funds for Brunswick and Hanover agreed upon by these autonomous administrations is currently being drafted in the North Saxon state parliament. The merger of the regional pension insurance funds for Berlin and Brandenburg agreed upon by the two autonomous administrations seems to have been slowed down by political difficulties. In the autumn of 2002, the regional pension insurance funds for Rhineland-Palatinate and Saarland agreed to work together.

The Railway Insurance Fund and a further nine regional pension insurance funds have set up a joint data-processing centre in Würzburg; the Maritime Insurance Fund will participate in a data-centre association in the North.

Also in autumn 2002, the Federal Insurance Fund for Salaried Employees and the Federal Insurance Fund for Miners concluded an agreement for the Miner’s Pension Insurance to take over some tasks of the Federal Insurance Fund for Salaried Employees in the chemical industry, and the glass, ceramics, leather and paper manufacturing sectors (involving about 500,000 insurance scheme members).

The Railway Insurance Fund provides pension projections for individual accounts – currently limited – for the Insurance Institution for Salaried Employees in Cottbus. In addition there are plans to strengthen the co-operation of these special insurance funds.

38. The GSAC views reform of the organisation of the pension insurance scheme as necessary, particularly given a likely further

decline in the numbers of blue-collar workers in the scheme. This will alter how duties are divided between regional pension insurance funds and the Federal Insurance Fund for Salaried Employees to ensure the scheme's effectiveness and efficiency. In this context, the GSAC welcomes the announcement made by the Federal Ministry of Health and Social Security to resume discussions in this legislative period with the aim of completing the present reform.

Excursus: Change of the access factor in the case of early retirement

The GSAC would like to contribute the following remarks regarding the design of a rate of reduction in the case of early retirement to current discussions.

a. Actuarial basics

39. Actuarial reductions are intended to have the effect that early retirement, i.e. the pension is drawn before the normal retirement age, is financially neutral for all insured persons. The longer period of pension payment represents neither a financial advantage (or burden) for those in a scheme who retire early nor a burden (or a corresponding advantage) to the insured community. The cost neutrality is given if the access factor (section 77, Social Code, part VI) lowered by the reduction and multiplied with the present value of the pension (i.e. all future pension payments) equals the present value of the pension at normal retirement age minus the present value of the then pension contributions, which continue to be paid. The rate of reduction represents the ratio of the reduced net payments in the case of a normal retirement age to the reduced

pension payments in the case of early (and therefore actual) retirement. Therefore, the rate of reduction is always smaller than 1. This rate of reduction must be multiplied with the regular pension amount and thus adjusts the pension amount to the extended pension term.

40. The earlier retirement is taken, the longer is the flow of payments and the lower are the insurances' revenues. Reductions are meant to neutralise this "double burden". Actuarial reductions leave the ratio of the pension's present values unchanged, irrespective of whether retirement begins at normal retirement age or earlier. In other words, the pension system does not influence the retirement decision if the present values of the additional income are not changed when a insurance member works longer.

41. An actuarial reduction is seen as incentive neutral: the decision about when to take retirement is not influenced by this reduction, but rather is made according to personal preferences and expectations. A reduction which is incentive neutral for the individual means financial neutrality for the whole insured community. This neutrality always refers to a longitudinal study of the whole pension term of an individual or a particular group. In a cross-section study an early retirement always means a fiscal burden for the pension system in the sense of omitted revenues and additional expenses. Incentive neutrality can be given for the individual insured only ex ante, an ex post identity of the present values happens not certainly (or better: certainly not). But for the whole insured community the present value's ex post identity must happen in a longitudinal study, otherwise the financial neutrality

due to the reduction would not be achieved. It is obvious that even with (incidence of) financial neutrality for the whole insured community, the incentive neutrality for the individual insured is not necessarily given because one single factor cannot meet the requirements of a heterogeneous group from an actuarial point of view. I.e. even with actuarial reductions which neither burden nor disburden the pension system in financial terms, the individual retirement decision can be influenced. Given incentive neutrality for the individual insured leads to financial neutrality for the whole insured community (given that the individuals act rationally), but the reverse is not true.

42. Because the rate of reduction represents the ratio of two present values it depends on the interest rate that is used to reduce future contributions and expenditure. The approximation of the future payment flow's "return" in the pay-as-you-go system with either the market interest rate or with the pension adjustment rate is the subject of controversy. Because the further life expectancy of the insured is part of the present value calculation, one possible disadvantage for all insured who have a life expectancy beyond this value is that they will draw a reduced pension. The fact that the statutory pension insurance scheme does not differ between different life expectancies for women and men results in a reduction rule giving a strong incentive for women to postpone retirement in comparison to men. In other words, with an actuarial reduction calculated on the average future life expectancy of men and women it is always worthwhile for men to retire early while for women it is better to postpone retirement. It is not worthwhile for women to retire early if the average future life expectancy of men is taken as a basis. In this approach, any dependant's pension is not taken into

account. The differences converge if the dependant's pension is taken into account since a pension for a man is often followed by a widow's pension but a pension for a woman is rarely followed by a widower's pension.

b. Regulations for the German Statutory Pension Insurance Scheme

43. The normal retirement age in the statutory pension insurance scheme is at present 65 years. Given that the actual timing of retirement differs from this age, the pension amount is adjusted over the whole period of pension payment. In that the pension amount depends (among other things) on the number of insured years, a pension receipt starting earlier than the particular pension age in each pension category means a corresponding lower monthly pension due to the fact that the contributions were paid over a shorter period of time. An insured person with a constant income over a period of 40 years receives a pension lowered by 2.5 per cent if he draws the pension one year early (or a corresponding higher pension if he postpones retirement). In addition, there is the correction of the access factor in the pension formula, which has to be adjusted with the corresponding reduction to allow for the retirement date. The access factor has the value 1 given retirement at the normal retirement age. The access factor together with the pension is cut by 0.003 for each month (=0.036 per annum) if retirement is taken early. Because special actuarial reductions in the pension as compensation for a longer period of pension payment were regarded as untenable this rule was disregarded during the pension reform of 1972. But in the course of that reform a bonus, in

force from 1973, was introduced which increased the monthly pension if the insured postpones retirement beyond the age of 65. This bonus amounting to 0.005 per month (= 0.06 per annum) remains unmodified.

44. The current reduction rule was introduced in the 1992 pension reform to counteract the growing financial burden caused by the demographic trend in the statutory pension insurance. The kind of early retirement that has no effect on the individual's final pension was, and still is, a widely used option. Cutting the amount of pension payment by 0.3 per cent for each month of early retirement should have the effect that despite a longer pension term – considering the omitted contributions – the same reduced pension volume, as would have been the case with a retirement at the age of 65, is paid out. The maximum possible reduction is 18 per cent with a pension drawn 5 years early.

45. As a result of the increase in the normal retirement age since the 1992 Pension Reform Act, the following transition rules in the different categories of pension have been applied until the increase in the state retirement age is completed in the year 2004. From 2012 onwards, there will be no longer an early retirement option from the age of 60, but only from the age of 62. (see appendix, table 1)

46. A pension for partial or full decreased earning capacity is cut if it is claimed before the age of 63. The reduction is 0.3 per cent for each month the pension is claimed before the age of 63. The maximum reduction is 10.8 per cent in the case of claiming the pension at the completed age of 60. If the pension is claimed even earlier, the

reduction is calculated under the assumption that the pension starts at the age of 60 because of an extension in the supplementary periods by this time. The reduction in pensions for decreased earning capacity was altered from January 1st, 2001. A provisional right makes a lower maximum rate valid for retirement taken before November 30th, 2003. This rate is increased gradually until the maximum rate for a pension reduction is 10.8 per cent in case of a retirement from December 1st, 2003. There is no reduction in pensions for occupational invalidity and disability respectively if a claim was made by December 31st, 2000.

47. Reductions in the dependant's pension come into force on January 1st, 2001 so that the dependant's pension is aligned with retirement age limits. Thereby reductions apply if the insured dies before the age of 63 and bonuses apply if the insured dies after the age of 65, but had not claimed his old-age pension at that point. The earliest possible retirement was notionally fixed at 60, which allows for a maximum reduction of 10.8 per cent.
48. The reduction calculated at the start of retirement holds for the whole period of pension payment, i.e. an old-age pension following a pension for decreased earning capacity, for example, is reduced by the same scale. But the reduction for a dependant's pension is always adapted according to the (deceased) insured person's pension entitlement. In 2012 the old-age pension for women and the old-age pension paid because of unemployment or partial retirement cease completely. At that point early retirement is only possible under the old-age disability pension, the old-age pension for long-term insured and the pension for decreased earning capacity.

c. Regulations in other countries

49. In the pension insurance system in the USA the pension is reduced up to 36 months by an *actuarial rate of reduction* amounting to 5/9 (=0.56) per cent per month if the pension is claimed early. For each month exceeding the 36 months the rate of reduction is 5/12 (=0.42) per cent per month, which implies that in this time period early retirement is relatively more worthwhile due to a lower rate of reduction. A person born after 1960 to whom the new state retirement age limit of 67 is applicable (to persons born prior 1960: age of 65) has to accept a 30 per cent pension reduction if the pension is claimed 5 years before the normal retirement age (36*5/9+24*5/12+30). If the pension is deferred beyond the age of 65 it is increased by a *delayed retirement credit,* which will be raised gradually –following the pension reform of 1983- until 2009 when it amounts to eight per cent. I.e. for each year retirement is deferred beyond the normal retirement age the pension is increased by eight per cent.

50. In Finland a normal retirement age of 65 is applied whereby an early retirement is possible from the age of 60 onwards. The individual pension level increases from the age of 23 for each year worked by 1.5 per cent. To increase labour (force) participation of the over 60s an increase in the pension level by 2.5 per cent for each year work beyond the age of 60 was brought in 1994. The old-age pension calculated by multiplying 1.5 per cent of the individual's average salary (with reference to the last working years before retirement) with the number of working years is reduced by 0.4 per cent for each month (= 4.8 per percent per annum) the pension is claimed before the age of 65. A retirement 5 years early implies a pension reduction by at least 24 per cent. In addition, a 2.5

per cent yearly increase in the individual pension level is foregone from the date of early retirement. If the retirement is deferred beyond the age of 65 the pension is increased by 0.6 per cent for each month (=7.2 per cent per annum) worked beyond the age of 65.

51. In Sweden there is no normal retirement age. The insured person can choose his or her individual retirement age unrestricted from the age of 61 on. In calculating the pension, the pension amount is divided by a factor that is decided by the future life expectancy of the age cohort in which the insured stands at his retirement date. The younger the insured is at retirement the higher the future life expectancy is and therefore the pension reduction. No difference is made between the differing future life expectancies of men and women. Before the pension reform (which was agreed in 1994 and affects fully those born after 1954) the pension was cut by 0.5 per cent for each month the pension was claimed early, i.e. before the age of 65. A retirement 5 years early implied a pension reduction by 30 per cent. The "reward" for deferred retirement was a 0.7 per cent pension increase per month.

52. In Switzerland the normal retirement age ("*ordentliches Rentenalter"*) is 65 for men and 63 (64 after 2005) for women, early retirement and therefore a reduced pension is possible from the age of 62 for women and the age of 63 for men. The retirement date can be brought forward only by complete years (either one or two), bringing it forward by single month is not possible. A deferment can be made for at least one year and for a maximum of five years and here a graduation in months is possible. Reduction

and bonus are adjusted periodically according to wage trends and inflation together with the pensions. For men the reduction rate is 6.8 per cent per annum, for women it is 3.4 per cent per annum until the rules are aligned from 2010 onwards (see appendix, table 2). The pension reduction amounts to a maximum of 13.6 per cent due to the fact that a pension can be claimed at most two years early.

The current regulation complies with the calculation of the pension reduction according to actuarial basic principles as women have a higher life expectancy and therefore expect lower reductions of the monthly pension amount. This will not be the case in the future because of an equalisation in the reduction rate.

53. In some of the aforementioned countries where the reductions are higher than in Germany (USA, Switzerland (men)) the average actual retirement age is above that in Germany. This is also true for Sweden where pensions – as a result of consideration of the further life expectancy which is specific for each age group in the pension formula – are reduced at retirement date. In Finland, where the reductions are higher, the average retirement age is below that of Germany. Obviously, when making a decision about retirement many factors play a role – e.g. the situation on the labour market or the demographic development. The size of pension reductions is nevertheless an important contributing factor. It is clear that the regulations mentioned above have in part a greater flexibility than the German ones as the reductions and bonus regulations are adjusted according to economic and/or demographic trends. Thereby an adjustment of the pension amount to demographic

trends as in the Swedish pension system corresponds particularly well to the actuarial concept of reduction calculation.

d. Determination of reduced access factor

54. There are several methods to calculate the size of the reduction. As a basic principle it is determined if the financial neutrality refers exclusively to the old-age pension's volume or jointly to the old-age and widow's pension's volume together. Moreover the age until the reduction is in effect is determined. In Germany the reduction is applied both to the old-age pensions and the widow's pension, i.e. financial neutrality is given on early retirement if the reduction represents the ratio of the present value of the old-age and widow's pension's volume minus the present value of the revenues at the normal retirement age to the present value of old-age and widow's pension's volume at early retirement. As there is only one rate of reduction for all insured groups and also no difference is made between age specific reductions only a rough, i.e. average approximation to the different actuarial values is possible. As the basis, the calculation uses the 1982/84 mortality tables for men, an adjustment to actual mortality rates would imply a lower reduction. If the market interest rate were taken as a basis for the calculation of the present values, the rate of reduction would be higher.

55. Personal assessment about current and future consumption level plays an important role for the individual when he or she is deciding what the optimal personal retirement age might be. In searching for the optimal retirement age, the rational insured compares the present values of all future pension payments minus the contributions to be paid for all potential retirement ages. If the individual time preference rate is in line with the interest rate which

is used to reduce the present values to calculate the actuarial reduction, the individual does indeed face a system that for him is incentive neutral. If according to his preference structure, the time preference rate is above the interest rate current consumption is appreciated more. Then for this insured person the incentive neutrality is lost and he is likely to claim early retirement despite actuarial reductions. To prevent such a person taking an early retirement, the reduction has to be higher. This makes it clear that the actuarial reduction can be no more than a rough approximation as each individual has a personal time preference rate depending on his or her situation.

56. The GSAC intends to make this topic a research project.

VII. Conclusion

57. The increase in the contribution rate in 2003 as a result of the negative economic trend marks again a further departure from the contribution rate path aimed for in the 2001 pension reform. With the introduction of an additional capital-funded old-age provision the pension reform 2001 implemented the right position of points for a long-term stabilisation of the pension system. Nevertheless, developments in 2002 reveal a further need for reform in the statutory pension insurance. On November 21st, 2002, the Federal Government set up a commission to examine sustainability in financing social security systems. The GSAC is to participate in the discussion about the pension insurance scheme's further development.

The GSAC believes that for the pension insurance' long-term stability and in order to recover the trust of the current and future contributors in the central system of the German old-age security it is necessary to reach a broad political consensus – as in 1989 – for measures regarding further adjustment of the pension insurance to changing demographic, economic and social conditions.

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