Report of the German Social Advisory Council on the Federal Government's 2003 Pension Insurance Report

Contents

I. Introduction

1. The German Social Advisory Council (GSAC), in accordance with its statutory duty (section 155, Social Code, Part VI), comments on the Federal Government's 2003 Pension Insurance Report. This statement deals first with those parts of the report concerned with future development, i.e. medium-term projections and model calculations over the next 15-year period. The GSAC bases its comments on access to calculation results and information on the underlying assumptions of the Pension Insurance Report. Furthermore, the GSAC was able to draw on additional explanation and information from staff at the Federal Ministry of Health and Social Security.

2. Stagnating economic development and the consequent past poor development of contributory income, has lead to short-term legislative measures being needed to be taken in the area of Statutory Pension Insurance. This is despite a background of recently improving early indicators of an upcoming recovery in economic activity. The GSAC comments on the proposed measures for avoiding the otherwise necessary increase in the contribution rate. Among these are the already third decrease of the minimum value of the fluctuation reserve to 0,2 of one month's expenditure, the complete financing of long-term care insurance contributions by the pensioners from April of the coming year, and the suspension of the 2004 pension adjustment.

3. As every year, the 2003 Pension Insurance Report describes the current and developing financial situation of the Statutory Pension Insurance Scheme. It includes a survey of predicted financial development over the next four calendar years based on the Federal Government's current assessment of medium-term economic trends, as well as long-term model calculations. The latter include financial development to 2017 based on nine model calculations generated by combining three assumptions regarding wage trends with three employment scenarios. These show not only the income and expenditure of the Pension Insurance Scheme, but also each of the required contribution rates.

4. These projections are made on the basis of law. They take into account measures having a financial bearing which are still in the legislative process. In particular these are drafts for a law to secure a sustainable financial basis for the Statutory Pension Insurance Scheme; a second law to change Part VI of the Social Code and other laws; and a third law to change Part VI of the Social Code and other laws.

5. Because of the financial integration of the German Statutory Pension Scheme for both West and former East Germany, the results are described jointly. However, as in previous years, medium-term calculations regarding income and expenditure for east and west federal states are presented separately.

6. The GSAC notes that contrary to section 154, subsection 1, sentence 4 of the Social Code, Part VI, the Pension Insurance Report will not be passed onto the legislative authorities by November 30, 2003. Instead it will first be dealt with at a cabinet meeting on December 3, 2003. The GSAC further notes that this failure to observe the deadline is acceptable since otherwise a report would have been presented which, though reflecting the current legal situation, would have failed to represent pending political objectives in the area of pension insurance: Drafts of a law to secure a sustainable financial basis for the Statutory Pension Insurance Scheme and a law to reorganize the taxation of pension provisions and old-age benefits will first be decided by a cabinet meeting on December 3, 2003. Therefore they could not have formed the basis of the report.

For the legislative authorities however, the 2003 Pension Insurance Scheme Report is only valid when based on current reform measures. The GSAC bases its evaluation on the most current version of the discussion within the Federal Government.

II. Statement on the medium-term projections until 2007 of the 2003 Pension Insurance Report

7. These projections are based on assumptions made by the inter-ministerial "National Economic Projections" team from the end of October 2003 for the coming year, as well as participating federal ministries from the end of April 2003 for 2005-2007. Based on these assumptions and the aforementioned statutory duty, and despite the worsening economic outlook, the contribution rate will remain unchanged at 19.5 percent until 2007. Without the previously mentioned legal measures, and based on these assumptions, the contribution rate for 2004 would have to have been set at 20.5 percent. The stability of the contribution rate until 2007 is a result of the planned increase of the fluctuation reserve to 1.5 of monthly expenditure. This will be examined further on in the report.

Already the previous year, the GSAC had indicated that the basic economic assumptions regarding the Pension Insurance Report were somewhat optimistic. In particular, the then-implicit expectation that a 1 percent increase in economic growth would lead to an increase in employment, went against past experience.

The decline in employment and the increase in the number of unemployed as well as the reduction in sales tax volume led to a reduction in the income of the Pension Insurance Scheme. Given the fixed benefit level, this would have made a raise in the contribution rate in 2004 necessary. Deciding against this, the government instead put forward a series of measures which will come into force in 2004. These will affect the reduction of the fluctuation reserve as well as the expenditures in the Pension Insurance Scheme.

8. The planned further reduction of the target value for the fluctuation reserve, henceforth referred to as the sustainability reserve, and wage development taking into consideration last year's introduction of the Right to Remuneration Conversion ("*Entgeltumwandlung*") in the context of occupational pension provision, increase the financial risks faced by the Statutory Pension Insurance Scheme. One year ago, the target value of the fluctuation reserve for the end of 2003 was estimated at 0.66 of one month's expenditure. The current fluctuation reserve stands at only 0.42 of one month's expenditure. This is yet another fact highlighting the risks involved in combining too low a target value for the sustainability reserve with over-optimistic assumptions regarding economic development.

Some relief though, will come from anticipated contribution rate trends in the area of Statutory Health Insurance. But set against the financial situation of the Statutory Health Insurance Scheme, decreases in contribution rates during the coming year will be barely noticeable. Greater financial impact however will be felt in the coming years. In line with the government's plan, pensioners will be fully responsible from April 1, 2004 for contributions to their long-term care insurance. This also means corresponding relief for the Pension Insurance Scheme.

9. In regard to the development of current pension values in the former East and West Germany, the report takes as its premise a further, albeit incremental convergence in the short-term until 2006. This convergence however will be interrupted by next year's cancellation of the pension adjustment.

A convergence of both current pension values will ensue with further pension adjustments. However, it is impossible at present to give a date by which the goal of equal current pension values will be reached.

10. At this point it should be noted that the financial situation of the Pension Insurance Scheme is significantly determined by trends in the former East Germany. In the years 2002 to 2007 yearly expenditure there is set to exceed income by 12.4 to 13.9 bn Euro. Crucial for this outcome are developments in employment levels since 1990. Then, the

number of employed stood at 8.6 million whereas only 5.4 million are employed this year.
If in time a faster convergence of current pension values between East and West were called for, this would entail not only disassociation from actual wage development but also significant further expenditure possibly over an extended period. On these grounds, the GSAC suggested already last year[1], leaving current practice as it is.

Note should be taken at this point of a provision within the consolidation package of the Federal Government, applicable in future to the former East German states. According to this, the level of pension adjustment there shall continue following the separate wage development but must not fall beneath that of the West German states. This contradicts the petition of the GSAC in its previous year's report which argued for a separate pension adjustment with the goal of convergence and eventual correspondence of current pension values in West and the former East Germany. On sociopolitical grounds however, the GSAC holds such a temporary solution for justifiable.

11. Against the backdrop of collective German development it should also be noted that the average pension payments due to reduced earning capacity and old-age in former East Germany lie at 104 percent for men and 136 percent for women, as against the reference value in former West Germany. The crucial factor here is an on-average longer insurance period for pensioners together with a much higher rate of employment for women in the former East. According to an evaluation of the "The Federation of German Insurance Institutes" *("Verband Deutscher Rentenversicherungsträger")* the average insurance period in former West Germany was 40.1 years for men and 26.2 years for women. In former East Germany it was 45.2 years for men and 36.1 years for women.

However, when evaluating particular income levels, one must take into account the fact that occupational pension provisions have until recently played only a minor role in former East Germany. Levels of private wealth are also, in so far as available data shows, lower in the East than in the West.

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[1] See report of the GSAC on the 2002 pension insurance report, passage 8

12. The annual pension adjustment of July 1st is also included in the medium-term calculations. This is determined by the planned new pension adjustment formula – development of gross wages modified by the change in the pension contribution rate, and taking into account notional contributions towards private old-age security as well as the sustainability factor. It ensures that pensioners enjoy economic growth as reflected in wage trends.

13. The projections also take into account the fact that at the end of 2004 the sustainability reserve will be cut to 0.25 of one month's expenditure. This is just barely above the reserve's bottom limit. The GSAC comments on this in detail later in this report.

III. Statement on the 15-year projections of the 2003 Pension Insurance Report

14. The presentation of long-term financial trends until the year 2017 uses the same methodology as in previous years. Once again nine variants taking wage rises of two, three and four percent are calculated from which one scenario with a lower and one with a higher employment trend are calculated. The figures show how the system reacts over the medium and long-term to different wage and employment assumptions.

15. In the scenario with the lower employment trend it is assumed that the number of workers and employees in the former West German states will rise by 0.1 million by 2017 (compare Overview B 13 of the Pension Insurance Report). The corresponding figures for the middle and higher employment trends are 1.2 and 2.4 million respectively. These assumed values are lower in the lower and middle variants, and higher in the higher variants compared with the Pension Insurance Report of last year. The margin of fluctuation between the variants is bigger, since the medium-term growth rates differ by

0.5 percent as opposed to 0.25 percent before. This concords with a proposal by the GSAC from last year.

Regarding wage trends, growth rates of 2, 3 and 4 percent of the average gross wage are assumed. At the GSAC sessions an assumption of continuous wage development of 4 percent was unanimously held to be unrealistic. Through this, false signals are being sent. This is especially so since these values find their way into pension information projections of the insurance agencies, which are then sent on to the insured at regular intervals. The written part of the Pension Insurance Report explicitly points out that the 4 percent projection variant is purely a model. The GSAC recommends dropping the 4 percent variant from future long-term projections and including only two wage-trend variations.

16. As in last year's report, three employment trends are laid down for the states of former East Germany. The lower variation is based on a long-term decline in employment of around 0.2 million by 2017, the middle variation around 0.1 million and the upper variation around 0.4 million. The figures for the lower and middle variants are lower than in last year's Pension Insurance Report. The model variants for the former West Germany are linked to the corresponding variants for the former East. Thus, the GSAC also deems proper the inclusion of only two employment trends for former East Germany.

17. It should be pointed out here that only limited comparisons can be made between the calculations of last year and those of the current report. This is due to changed economic assumptions.

18. The notional employment trend of the middle variant is in accordance over the long term with the assumptions of the "Commission for Financial Sustainability in the Social Security Systems".

19. The stated aim of the Federal Government was and remains, keeping the contribution rate until 2020 below 20 percent. With the 2001 pension reform the unfunded Statutory Pension System was supplemented by a state supported, capital-funded pillar. This innovation and the renewed modification to the pension adjustment formula have set a course to put the pension system onto a more sustained financial footing.

20. The "Commission for Financial Sustainability in the Social Security Systems" was appointed by federal minister Schmidt on November 21, 2002. Its mandate was to examine the systems of health, long-term care insurance and pensions with a view to producing proposals for their further development and sustainability. In the area of statutory pensions the commission reviewed the effects of the 2001 pension reform and considered how to continue this reform policy of expanding the capital-funded supplementary systems. In this context the commission also considered to what extent it is possible to continue with the paradigm shift towards the stronger income-orientated expenditure begun in the 2001 pension reform. The introduction of a sustainability factor in the pension adjustment formula and the future shifting of pension adjustment towards the development of wages subject to contributions are concrete outcomes of the implementation of commission proposals.

IV. Principles regarding the long-term projections

21. The long-term projections are a means of testing the influence of changes in the likely different assumptions made about future economic and demographic trends. They merely clarify the effect of the statutory pension system (especially in terms of contribution rate, pension level, federal subsidy) on the particularly relevant economic and demographic parameters (earned income, labour participation rate, etc).

22. The GSAC has underlined this frequently in the past and points out that model calculations by the Federal Government for the 15-year period in the Pension Insurance Report cannot be taken as prognoses. At best, and with numerous limitations, the 5-year projections could serve this function. These also form the basis for determining the necessary contribution rate for the coming year.

23. Long-term model calculations are only able to assess the effect of various measures and/or possible economic and demographic trends. For this reason one should be wary of taking one of the nine variants in the 15-year model calculation as the relevant or „most likely“ outcome.

24. Even though the results of the long-term projections are only modelled, it is nonetheless important to demonstrate their sensitivity regarding trends in contribution rates against changes in the underlying assumptions. In the 2003 Pension Insurance Report, it is shown how contribution rates, necessary to keep the target value of the fluctuation reserve fund within a corridor of 0.2 and 1.5 of one month’s expenditure, change according to changing assumptions made for wages and employment.

25. A change in wage trend, whether in the form of an increase or decrease of 1 percentage point, merely leads to a one-off effect of 0.2 contribution rate points. The following year’s higher, or respectively lower, pension adjustment almost completely neutralizes this contribution rate effect in the following year. Projections concerning the contribution rate cycle are therefore hardly affected by deviations in assumed employment growth. Deviations in assumed employment growth have a stronger influence on the contribution rate. Here the base effect is up to 0.8 percentage points. In total, the difference between the most and least favourable combination of assumptions comes to 1.0 percentage points.

26. The Federal Government assumes a drop to 12.2 percent by 2006 in the statutory health insurance contribution rate of the states of both former East and West Germany. Because of the modified wage adjustment for pensions, changes in the contribution rates to health insurance have no direct effect on pension adjustments. The pensioners’ contribution to this branch of social security insurance comes from their gross pension. Naturally a change in the contribution rates to health insurance affects the subsidy paid by pension insurance companies to health insurance. This subsidy corresponds to the employer's share of the contribution. If the contribution rates drop in this area, then net pension payments rise while the contribution rate subsidy to health insurance shrinks. The consequence is that a drop in contribution rates to health insurance of 1 percent through a reduction of these subsidies leads to a decline in the contribution rate to Statutory Pension Insurance of around 0.1 contribution rate points. Either a marked rise or decline in contribution rates to the statutory health insurance scheme could, over the long term, either negatively or positively affect the Federal Government's contribution rate targets for statutory pension insurance.

27. The GSAC points out that the 15-year model calculations do not cover the period in which the demographic burden will have its strongest influence. Given current legislation, the growth in contribution rates demonstrated in the model calculations will likely become stronger outside this time frame.

V. Regarding further developments in the 2001 Pension Reform and the stabilization of the contribution rate.

a. Short term measures affecting contribution rates in the 2003 consolidation package

a. a. Lowering the target value of the fluctuation reserve and prospects for building-up a higher fluctuation reserve

28. These days, the only function attributed to the financial reserves of the pension insurance scheme - the so-called fluctuation reserve - is balancing out short-term income fluctuations, unavoidable over the yearly cycle. The financial reserves are at their highest towards year-end due to one-off payments called "Christmas Bonuses" which are liable for contributions. They then decrease continuously throughout the following year reaching a low point in October/November. 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.

29. In the past, a fluctuation reserve target value of one month's expenditure has not led to a liquidity squeeze in the Statutory Pension Insurance Scheme – even with unexpected negative financial development. However a target value of half of one month's expenditure would have made the Pension Insurance Institutes dependent on liquidity support throughout the year in the years 1996 –1998, although it could have been paid back by year-end. But with the renewed lowering of the target value to 0.2 of one month's expenditure, funding gaps threaten to persist until the end of the year which would themselves cause a rise in the contribution rates the year after.

30. One element of securing the liquidity of the Statutory Pension Insurance Scheme can be achieved by regulating the monthly instalments of the federal subsidies. The possibility over the short term of preventing payment bottlenecks by making funds available from the 12 monthly payments of the federal subsidy has already been set out in the current budget plan. The GSAC deems proper, as expressed in the explanation of the draft bill for last year's Contribution Rate Stability Act (*"Beitragssatzsicherungsgesetz"*), the introduction of such a measure for safeguarding liquidity into federal budgetary law. This has since happened.

Moreover, the 1992 Pension Reform Act stipulates a "guarantee function" requiring the Federal Government to ensure the liquidity of the statutory pension insurance scheme. This means that the government can provide financial means if the fluctuation reserve, even taking into account advanced federal subsidies, is insufficient to fulfill payment obligations. Such means must be repaid by the pension insurance institutes in the following year. And these commitments would also be included when calculating the contribution rate.

31. With each lowering of the target value, the security function of the fluctuation reserve is diminished. This is even more so as the financial risks of pension insurance have increased overall. A drop to 20 percent of one month's expenditure in the target value of the fluctuation reserve would lead to liquidity problems in the course of the second half of the year.

It should also be noted that any discussion of liquidity constraints adds to general uncertainty and may weaken trust in the financial solidity of the pension insurance scheme. An adequate minimum-level for the fluctuation reserves is therefore essential.

32. Over the long term, the use of surplus income for building up a so-called "sustainability reserve fund" is envisaged. Initially at least, this will not be used to lower the contribution rate. The GSAC shares the Federal Government's view that the fluctuation reserve should not simply be viewed as a factor in controlling liquidity for the fiscal year of the Statutory Pension Insurance Scheme. The fluctuation reserve is also important for stabilizing the pension insurance contribution rate during cyclical fluctuations**.** This view should be strengthened over the long term. Conjunctively, in weaker cyclical phases the fluctuation reserves can be released. This is mirrored by the lowering of the target value for the minimum fluctuation reserve. It is however essential to replenish the fluctuation reserves in times of prosperity in order to ensure stabilization of the contribution rates in more difficult times.

a. b. Prompt transfer of contribution rate changes in the health insurance scheme

33. Each month starting from April 1, 2004, pension payments will take into account any change in the individual contribution rate to the Statutory Health Insurance Scheme, if the change occurred 3 months before this date. In the past, changes in contribution rates to Statutory Health Insurance only affected pension payments after pension adjustment on July 1 of each year. This was due to previous, much more protracted and not fully-automated administrative procedures.

34. The GSAC welcomes the prompt transfer of changes in pensioners' health insurance contribution rates. As next year's health reform measures should mostly result in drops in the contribution rate, for the majority of pensioners a change will increase the actual pension payment. Set against the impact of other measures this has a cushioning and therefore desired effect.

a.c. Reorganization of the contribution payment to long-term care insurance

35. Current contribution rate to long-tem care insurance is 1.7percent. Half of this, 0.85 percent, is borne by the pensioners. From April 1, 2004, they will pay the entire contribution. This corresponds to a monthly reduction in pension payments of 0.85 percent. The average "West" pensioner will see a monthly reduction of 10 € compared to 9 € for the average "East" pensioner.

36. Since its introduction in 1995, half of the contribution rate for long-term care insurance has been covered by pension insurance, as has been the practice for statutory health insurance. In line with the intended reorganization of long-term care insurance contribution for pensioners, this policy will be abandoned.
This measure means in effect that this half-payment of the long-term care insurance contribution rate by the pension insurance is financed by insured pension contributors. Consequently it affects the size of the required contribution rate. The complete shifting of the burden to the pensioners will lead to an estimated yearly relief to the statutory pension insurance scheme of around 1.6 bn €. This corresponds to an effect on the contribution rate in the region of 0.1 to 0.2 percentage points.

37. Considering that the social long-term care insurance was first introduced in 1995 and that virtually only older people, who have contributed little, are its beneficiaries, the intended measure seems reasonable. This is all the more so as these financial restructuring measures are linked to limited cost-of-living adjustments in social long-term care insurance services, which predominantly benefit pensioners. A proportionally heavier burden thus seems fair. This takes into account both intergenerational equity and most especially the fact that the employed had to give up a holiday to help finance the long-term care insurance.

The GSAC believes this measure to be an instrument for short-term stabilization of the pension insurance contribution rate, but at the expense of long-term lowering of the pension level.

a. d. Suspension of the 2004 Pension Adjustment

38. In keeping with the plans of the Federal Government, the pension adjustment of July 1, 2004 shall be suspended. The next adjustment would then take place on July 1, 2005. According to current data, an adjustment of pensions on July 1, 2004 would – considered in isolation – lead to an increase in pension contribution rates of 0.6 percent. A suspension will result in a drop of around 0.7 bn € in Statutory Pension Insurance expenditure by January 1, 2005. Calculated as contribution rate points, this is just under 0.1 percent.

39. A discretionary intervention in the form of a suspension of the pension adjustment set against a background of continuing weakness in growth and employment is acceptable in the interest of stabilizing employment costs. This is despite being the first time since 1958 that the annual pension adjustment is suspended. The Statutory Pension Insurance Scheme is a mutually supportive group. This means that all members share benefits but also risks inherent in, for example, weak employment trends. In this respect any financial loss to individual pensioners associated with the pension adjustment suspension does not constitute a disproportionate imposition.

b. Long-term measures affecting the contribution rates in the 2003 consolidation package

b. a. Introduction of a sustainability factor in the pension adjustment formula

40. The Federal Government plans to integrate a so-called "sustainability factor" into the pension adjustment formula. This factor has its origins in the work of the "Commission for Financial Sustainability in the Social Security Systems". Its final report was presented in August this year.

Thereafter an additional factor will be added to the pension adjustment formula which will mirror changes in the numerical relation between contributors and benefit recipients. In this way changes, which are important for the financial situation of the pension insurance scheme, will be taken into account in regulating the annual adjustment rate. Of particular importance here is the demography of aging. Key to the sustainability factor is attaining higher pension adjustments when the number of contributors increases in relation to the number of pensioners. Conversely, an increase in the number of benefit recipients should lead to lower pension adjustments. With the sustainability factor a "stabilizing rule" will be built into the pension adjustment formula.

41. The sustainability factor is not, as is occasionally misstated, identical to the "demographic factor" introduced by the 1999 Pension reform. This factor, which never came into operation, was meant to decrease the pension adjustment, should average life expectancy at an older age, in particular at retirement age, increase**.** The sustainability factor on the other hand, is based on the relation between pension contributors and recipients. It also takes into account not just changes in average life expectancy but especially birth trends, migratory movement and employment trends.

The result of these considerations is expressed in the following new adjustment formula.

$$AR_{t+1} = AR_t * \frac{BE_{t-1}}{BE_{t-2}} * \frac{100 - AVA_{t-1} - RVB_{t-1}}{100 - AVA_{t-2} - RVB_{t-2}} * \left(\left(1 - \frac{RQ_{t-1}}{RQ_{t-2}} \right) * \alpha + 1 \right)$$

where AR = current West German pension value

BE_{t-1} = average gross wage earned during the last year (if t=current year)

BE_{t-2} = average gross wage earned in the year before last year taking into account the change in gross wages liable to contributions per average employee not including civil servants but including unemployment benefit recipients

AVA = share paid into additional old-age provision scheme

RVB = pension insurance contribution rate

RQ = pensioner quotient = equivalence pensioner/ equivalence contribution payer

α = distribution weight

42. The numerical ratio of contributors and pensioners is standardized within the formula. This should prevent for example, the artificial inflating of pensioner numbers through an increase in the number of lower pensions which, for instance, could be traced back to shorter insurance periods. To this end all pensioners are translated into standard pensioners ("*Eckrentner*") (45 insurance years based on average earnings). By the same token the standardized number of contributors is calculated as a computed quantity of compulsorily-insured average wage earners. Standardization fairly well immunizes the adjustment formula against structural changes in pensioner and contributor numbers.

43. Lastly the pensioner quotient is weighted by a factor of α, set at 0.25 in the legal draft. This is to ensure that the contribution rate to pension insurance until 2020 does not rise above 20 percent, or 22 percent by 2030. These are the targets for the contribution rate already laid down in the 2001 law.

44. The sustainability factor produces too, a short-term stabilizing effect. Should the number of equivalence contributors decrease with the cycle as in the present situation, then the next pension adjustment will be tempered so that a jump in the contribution rate can be softened or avoided. Conversely, should the number of contributors increase, or for example, countrywide employment go from part to full-time, then this will have a positive effect on the level of pension adjustment. In effect the pensioners are linked to the effects of cyclical fluctuations in that they contribute to the stabilization of the financial basis of pension insurance. However, they also participate in any positive economic trend reflected in increased employment and not simply, as was the case until now, those brought on by increased wages and their influence on the pension adjustment.

45. From this it can largely be assumed that the pension insurance system and target value for the contribution rate are better protected by the suggested sustainability factor from actual deviations in demographic and particularly labour-market related assumptions. This is because the sustainability factor takes into account not just birth and immigration trends, but especially changes in employment behaviour.

At the same time pension levels will decline until 2030. Taking into account the effects of the 2001 Pension Reform, gross pension level will decrease from the then 48 percent to around 40 percent. Taking into account the shift to deferred taxation of pension, net pension level, then at around 69 percent will probably drop to under 60 percent. It must be noted here that net pension level as an indicator loses a lot of its significance.

b. b. Abolition of accounted periods for time spent in education

46. The previous maximum-period of three years of further education counting towards the pension shall be abolished. A transitional period of 4 years starting from 2005 is envisaged. This measure will eliminate the hitherto advantage created by pension law which benefited insured persons who had spent time in further education from the age of 17. Such points-for-time periods will however be taken into account as gap-filling measures. This is significant for the pensions of those early-disabled and for completing requisite insurance years of those long-term insured. Vocational education combining schooling and practical training, e.g. the nursing/caring professions, are not affected by this measure. In these cases time spent in education will still be counted.

The 1992 Pension Reform Act reduced the accounted periods in further education from 13 years to 7. Since 1997, only 3 years from the completion of the 17th year are allowed for. However a right to compensation was granted for invalidated periods, though according to current (unattractive) values.

47. The intended measure has been publicly criticized in part as a hindrance to further education. The GSAC does not share this appraisal. On the one hand a decision made in very young years for a particular type of education is unlikely to have been made in the context of a later pension. On the other hand, the financial loss can be categorized as bearable particularly within a social group which is likely to end up drawing a better than average pension. For them, this provision is also in the context of overall benefit level value and only comes into full force if pension applicants, subsequent to the transitional period, can demonstrate a complete insurance history without gaps.

All in all, the GSAC sees in the intended measure a strengthening of the equivalence in the pension insurance. From the point of view of contribution rate equivalence, the crediting of accounted periods can only be justified if contribution rates are paid from taxes.

b. c. Shifting the pension payment date for new pensioners

48. From April 1, 2004, payment of future pensions will – subject to the required vote in the upper house of the German parliament ("*Bundesrat"*) – be switched to the end of the month. Those whose have been drawing pensions since before April 1, 2004, will continue to receive it at the beginning of the month. Pension payment procedures shall be brought into line with those of unemployment insurance for example, where on-going payments are made at the end of each month.

49. Moving the pension payment date for new pensioners to the end of the month has an annual cost-cutting effect of around € 0.75 bn over a 20 year period, i.e. an entire pension generation. In the introductory year 2004 however, the possible financial gain shrinks by a quarter due to the introductory date of April 1. Above all, this measure aims at restricting expenditure.

Shifting the pension payment date for new pensioners to the end of the month causes only marginal strain in isolated cases. Those retiring from working life usually receive an extra pay-award from their job at the end of the month before their pension begins. Therefore shifting the date of pension payment will not create any financial gaps.

50. The GSAC considers justifiable the shifting of the payment date for pensions of new pensioners to a month's end. This is in consideration of savings thus gained, and the constraining effect on the level of the necessary contribution rate.

b. d. Abolition of the general over- evaluation of the first 36 calendar months with obligatory contribution periods

51. General over-evaluation of the first 36 calendar months with obligatory contribution periods was introduced by the 1992 Pension Reform. This was because at the time the data-situation of the Pension Insurance Institutes did not allow for differentiation of the reasons for lower wages and thus smaller contributions at the beginning of the insured period. As a result of improved data this general over-evaluation can now be focused on periods of actual job-training. Other periods, for example, periods of temporary work, are no longer over-evaluated. This serves to avoid an arbitrage effect and results firmly in a strengthening of the insurance principle.

b. e. Raising the state pension age for pensions on account of unemployment and following partial retirement

52. Current law allows insured persons to claim old-age pension on account of unemployment or partial retirement if; (1) they are 60 or over, (2) they are unemployed and were so for 52 weeks of the previous one and a half years before pension inception (at the earliest therefore, 58 1/2 - 60) – or were partially retired for 24 calendar months of the same period, (3) they have had 8 years of compulsory contribution out of the 10 years prior to pension inception, (4) they have fulfilled the 15 year waiting period.

The Federal Government intends reducing incentives to early retirement and increasing the actual retirement age. In this context the earliest possible entry age for old-age pension due to unemployment or after partial retirement, shall be raised in monthly instalments from 60 to 63 years between 2006 and 2008. Even allowing for pension reductions, drawing this type of old-age pension will no longer be possible before this time period. The Federal Government defends this reorganization as the legal pensionary consequence of the political change begun with the Hartz Laws ("Hartz-Gesetzen") which seeks to strengthen employment for older people. At the same time there will be confidence protection rules for insured persons who have already made legally binding arrangements about early retirement.

Moreover the legal draft contains a rule for the case of insured persons excluded from the special protection of confidence rules because they were still under 56 by the cut-off date. These rules come into force with the raising of the age qualification for early drawing of pension due to unemployment or partial retirement. The possibility is open to contractual parties who have made agreements about partial retirement to invoke frustration of contract (as long as the specific other conditions of Section 313 of the Civil Code are met), and request a consequent modification of the agreement (e.g. extension of work contract).

53. The actual average age at entry for old-age pension was 62.7 years in 2002. This is to be distinguished from the average age at entry for pensions on account of reduced earning capacity, which was 50.5 years in 2002. The oft-quoted average retirement age of 60.4 also takes into account pensions on account of reduced earning capacity and independent of age. This distorts the reality with regard to compulsory early retirement.

54. According to Federal Government assumptions, around 40 percent of insured persons avoid claiming reduced pension entitlements. With this in mind, the long-term projections assume a rise in the average retirement age of a further year. The raising of the entry age for earliest possible drawing of old-age pension due to unemployment or partial retirement, from 60 to 63 between 2006 and 2008, will boost the trend further.

55. At any rate, a majority in the GSAC perceives the planned reorganization positively, if as intended, it succeeds in increasing the employment quota for older people. With regard to more long-term considerations, this fraction of the GSAC emphasizes at this point that a phased-in raising of the general retirement age from 65 to 67, beginning in the next decade, is absolutely essential. It regrets that commitments to this end have not already been made.

c. Regarding Instrumentalization of the Statutory Pension Insurance Scheme in the area of Family Policy

56. Against the background, though not exclusively so, of Germany's low birth rate, it has been discussed since the fifties whether or not pension law should take child-raising periods more into account. Among the reasons advanced is that the pay-as-you-go financing of the statutory pension insurance scheme has in part caused the low birth rate. This is because older childless people profit from the contributions of the up-coming generation without having themselves contributed, either in a childrearing capacity, or through a higher rate of contribution to compensate for the missing „generative" contribution.

57. However, the assertion that the statutory pension insurance scheme is insurance against childlessness overlooks the fact that each obligatory system disconnects old-age provision from reproduction, irrespective of whether it is financed by pay-as-you-go or capital funding. In any case, every pension system that insures the individual against loss of income or poverty in old age is an insurance against childlessness. This is irrespective of whether the individual makes provisions voluntarily or compulsorily.

58. Besides recommending that parental periods be taken more into account, it is also suggested that pension contribution rates and/or pension benefits be considered according to the number of offspring. At first glance these recommendations are supported by the judgment on long-term care insurance by the Federal Constitutional Court (*Bundesverfassungsgericht*), (1 BvR 1629/94, April 3, 2001). This court holds unconstitutional the fact that child-raising and childless members pay equally into the Statutory Long-Term Care Insurance Scheme, despite the on-going contribution made by those with children to the functioning of the unfunded system. The court ordered the legislator to reorganize the system by December 1, 2004. In the meantime, the legislator is to check the consequences of the judgment for other branches of social security.

Against the background of this judgment, the GSAC has already stated that it does not see any urgent necessity to change either the rules of the Statutory Pension Insurance System or those proposals then undergoing legislation[2]. The range of pension insurance benefits accruing to those with children has been substantially expanded in past years. Since the 1986 Surviving Dependent's Pension and Childraising Act (*„Hinterbliebenenrenten- und Erziehungszeitengesetz – HEZG"),* considerable family-fostering elements have been incorporated into the range of benefits offered by pension insurance. These elements were expanded by the 1987 Childrearing Benefit Act (*„Kindererziehungsleistungsgesetz – KLG").*
Furthermore, child-related measures have been expanded by the introduction in 1992 of childrearing periods which are taken into account by the pension system. These are the approval of a 3-year childrearing period per child for births since 1992, and the gradual increasing of the value of these periods from 75 to 100 percent of average income by 1998. Moreover, the 2001 Pension Reform introduced not only a higher evaluation of contribution periods during parenting up to the child's 10th year, but also a supplement for the remuneration points with respect to child-rearing periods in the surviving dependents' pension. Parenting benefits may also be construed as contribution-rate savings. When child raisers receive benefits they have not paid for, this is as if they had

[2] Bundestags-Drucksache 14/6099

received significant contribution-rate relief. Pension entitlements alone for the childrearing period of a first child currently correspond to a contribution payment of at least €17,000. If one assumes, for example, two children and an additional child-rearing period of 4 years at 0.33 remuneration points each, one arrives at an equivalent value of almost € 42,000.

59. Currently discussed suggestions for differentiating between contributions paid by insured persons with children and those without would have the effect of valuing childrearing periods more in terms of benefits derived than contributions made. The GSAC rejects such proposals out of practical and principle considerations. A contribution malus for the childless insured leads to a reduction in the rate of return linked to the contribution paid. The rate of return might even become negative. The first possibility would conflict with the principle of participatiory equivalence, i.e. that same amounts of income subject to contributions lead to the same amount of pension entitlements. The second, a negative rate of return on contributions paid, would conflict with the ownership protection according to article 14 of the constitution with respect to pension entitlements earned with contributions**.** Thus, using the additional income from the contribution malus to improve benefits to insured child raisers would harm the fundamental principles of the pension insurance scheme, i.e. participation equivalence and income orientation of the benefits.

On these grounds the GSAC is against the instrumentalization of the Statutory Pension Insurance Scheme in the area of family policy.

Family policy and a concordant higher pensionary evaluation of parenting is a task which concerns the whole society and as such, should be financed from tax revenue.

d. Regarding pension information

60. The 2001 Pension Reform obligated the Pension Insurance Institutes to regularly update the insured with regard to their individual pension entitlements and the consequent level of their expected pension. In its special report on the reform[3], the GSAC welcomed this attempt to increase the transparency of the projected pension benefits. This was because it created the possibility of becoming aware of possible pension deficits and making accordingly timely provisions. The Pension Insurance Institutes began sending out this pension information already last year.

61. There has been some public criticism that adjustment figures no longer reflecting current and future conditions, were used in projecting already earned entitlements onto a standard old-age pension starting at 65. A hypothetical and continuous adjustment rate of 3.5 percent, for example, would create the illusion that extra provisions were unnecessary. Even warnings that future-pension figures cited in the pension information cannot be compared to current income in terms of purchasing power, due to rises in cost of living, are unhelpful as they are frequently either not understood or overseen. Objections like this must be taken seriously. The GSAC, as previously indicated, perceives here a similar problem in respect of that variant of the pension insurance report's projections based on an average income increase of 4 percent.

62. With the introduction of pension information, the Federation of German Pension Institutes carried out a survey among its beneficiaries.[4] This was to ascertain how this new service was received by the insured. In particular it investigated whether the imparted information was comprehensible and sufficient, and of what use it would be in personal pension planning. The majority of the insured are satisfied with the amount and quality of information about the retirement provisions of the Statutory Pension Insurance Scheme. However, the complexity of the matter means that not all the material presented is equally positively rated.

Insured persons felt that the pension information provided good advice in planning for their personal old-age provisions. 89 percent of those who read it found it either very helpful (31 percent), or reasonably helpful (58 percent), in planning their old-age provisions. The results of the survey suggest that a large majority found the pension

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[3] See special report of the GSAC on the 2001 pension reform, passage 82 ff.

[4] See (in German) Michael Stegmann, Michael Roth und Thorsten Heien: Die Renteninformation im Urteil der Versicherten: Ergebnisse der Versichertenbefragung 2002, Deutsche Rentenversicherung Jg. 2003, S. 556 ff.

information to be an appropriate and suitable medium for informing them about their personal pension entitlements and its development. The survey also found that there are communication problems with insured non-Germans. In particular they face substantial hurdles in engaging with the material and comprehension is less. The main barrier seems to be language.

63. With respect to future-pension projections of already-earned entitlements to old-age provisions, the GSAC suggests on the one hand, no longer including assumptions of adjustments. Only when the projected entitlements are seen in relation to current pension values, will insured persons be able to properly compare their future pension with current income and then be in a position to spot possible gaps in their retirement provisions. On the other hand, the expected old-age pension cannot be known when the individual retirement age is some ways off in the future. This is because the uncertainty about future employment is simply too big. It is thinkable however, that such an estimate may be attempted after the age of 40 when uncertainties over future income are somewhat more manageable.

e. Reform of the taxation of pensions

64. In May of this year the GSAC concerned itself with questions regarding pension taxation. This was in the context of a response to the final report by the council of economic experts on the reorganization of tax-law treatment of old-age provisions and old-age benefits from March 11, 2003. The assessments have not changed since then.

VI. Conclusion

65. With the increase in the contribution rate in 2003 brought on by negative economic development, Government policy once again moved away from the contribution rate path targeted by the 2001 pension reform. The introduction by this reform of an extra capital-funded old-age provision implemented the right position of points for a long-term stabilization of the pension system. But developments in 2003 clearly demonstrate the need for further reform in the area of statutory pension insurance. The GSAC will continue to participate in the discussion on further development of pension insurance.

66. The Statutory Pension Insurance Scheme is the central system of German old-age security. The GSAC believes that its long-term security and the recovery of the trust of current and future contributors is best served by reaching a broad political consensus, - as was done in the 1992 Pension Reform Act passed in 1989 **-** regarding further adjustment of the pension insurance to the changing demographic, economic and social conditions.

Berlin, November 28, 2003.

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