Report of the German Social Advisory Council on the Federal Government's 2007 Pension Insurance Report

Contents

I. Introduction

1. In accordance with its statutory duty (section 155, Social Code, Part VI), the German Social Advisory Council (GSAC) comments on Federal Government's 2007 Pension Insurance Report. This statement addresses firstly economic development in 2007 as well as political measures regarding pensions discussed in the 2007 report. Thereafter, the details of the 2007 pension insurance report that refer to future development, i.e. projections over the medium-term and the model calculations for the next 15-year period, are addressed.

2. The GSAC makes its comments based on its access to the calculation results and to information on underlying assumptions as well as to the text of the 2007 draft report on the pension insurance scheme. The GSAC was also able to approach the Federal Ministry of Work and Social Affairs for additional information and explanation.

II. Economic development in 2007

3. The marked up-swing in the German economy has continued in 2007. According to the German Council of Economic Experts' (SVR) forecast made in its 2007/08 annual report, the 2.6 percent rise in the actual gross domestic product in 2007 should fall only marginally short of the 2.9 percent rise seen in 2006. Therefore, 2007 should also see an above-average increase in the gross

domestic product in comparison with previous years. The uncertainties arising from the crisis in the financial markets and the rise in VAT have slowed economic growth. Moreover, in the run-up to the increase in VAT consumers brought forward purchases, particularly of consumer durables, by a considerable amount. Therefore in 2007 private consumer expenditure (c -0.1 percent) is likely to remain static. As a result of the reduction in purchasing power, domestic demand decreased. Thus 2007 is likely to see lower growth in domestic demand — 1.5 percent — compared to 1.9 percent in 2006.

4. Thanks to the continuing economic revival, there was a further fall in unemployment in the course of 2007. According to figures from the German Federal Employment Agency, the unemployment rate for the entire civilian labour force stood at 8.2 percent in October 2007 following 9.8 percent in October of the previous year. In absolute terms, since October 2006 the number of unemployed has fallen by about 650 000 to 3.34 million. This positive development is also visible as regards the long-term unemployed. In October, the number stood at about 1.24 million and had fallen by 350 000 compared to the same month the previous year.

5. There was an above-average fall in the number of older unemployed. In the 55- to 64-year- old age group there were about 426,000 registered unemployed in October 2007. This was about 107,000 or about one fifth fewer than in the same month

the previous year. Thus, unemployment among 55- to 64-year-olds has fallen considerably further than the average for all age groups, which has fallen by 16 percent. Whereas in earlier years the unemployment rate for older workers stood significantly above the total unemployment rate it is now converging with the total unemployment rate.

6. The upswing also had a positive effect on the number of employed. According to estimates from by the Federal Statistics Office, in September 2007 the number of the employed stood, for the first time in many years, at 40 million. Compared to the same month the previous year this represents an increase of 1.7 percent or about 676,000 people in employment**.** The employment rate rose to 70.7 percent. Again among older workers the increase is above average. The employment rate among 55- to 64-year-olds rose to 52 percent in the second quarter of 2007. This means that the employment rate has risen by more than 10 percentage points since 2000 and is considerably above the values seen in 2006 and 1998 which were 48.4 and 37.7 percent respectively.

7. The increase in employment was mainly seen among that sector of the workforce liable for social insurance contributions. According to preliminary estimates from the German Federal Employment Agency, the number of employed persons liable for social insurance contributions rose to about 27.4 million in

September 2007. This represents, respectively, about 577,000 people or a 2.1 percent increase from September 2006.

8. In earlier years, significant differences between the old and new federal states (the former West and East Germany) concerning the development of jobs liable for social insurance contributions were discernible. Whereas in 2005 in the old federal states a one percent decrease was noted, the decrease in employment liable for social insurance contributions was about three percent in the new federal states. The data for 2006 show that the economic upswing had a slightly stronger effect on the labour market in the new federal states. Thus, jobs liable for social insurance contributions rose by 2.1 percent in the new federal states, a considerably greater increase than in the old federal states, which saw a 1.5 percent increase. According to currently available data for 2007, both old and new federal states should benefit to roughly the same degree (2.1 and 2.3 percent respectively) from the increase in jobs liable for social insurance contributions.

III. Statement on the medium range projections until 2011

9. The assumptions made by the inter-ministerial “National Economic Projections” team from October 25, 2007, form the basis of the medium range projections for the years 2007 to 2011 in this year’s pension insurance report. The basic economic assumptions in the medium variant are based on the key points compiled in 2003 and further developed by the “Commission for Sustainable Financing of Social Security Systems”. The projection concerned with demographic development is geared to the assumptions made by the Federal Statistics Office’s11th coordinated population projection in November 2006.

10. These projections are made on the basis of the relevant law. They also take into account measures that have a financial bearing on the pension insurance scheme that are still in the legislative process. This means for the pension insurance report this year specifically taking into account the effects of the law passed on promoting additional old-age pension schemes and on an amendment to the Social Code, Part III. In addition, the effects of passing a sixth law amending the Social Code, Part III as well as other laws and the effects of the draft of the law on structural development in the long-term social care insurance scheme (*Pflege-Weiterentwicklungsgesetz*) have been taken into account when calculating the projections. The two latter measures influence the gross pension level due to changes in the contribution rates regarding stimulating employment and the

social long-term care insurance. The 2007 pension insurance report states a contribution rate of 3.3 percent towards the German Federal Employment Agency. This is in line with the legislation passed on November 16, 2007.

11. In accordance with the assumption made by the inter-ministerial team, the 2007 pension insurance report also expects that in the course of the cyclical recovery the actual gross domestic product grows by 2.0 percent in 2008. This assumption is marginally above the 1.9 percent increase estimated by the German Council of Economic Experts (SVR).

12. As regards the size of the labour force, the projections are based on the assumption that it will increase by 0.7 percent in 2008 and by 0.2 percent each year in the medium term thereafter. Compared to the assumptions made the 2006 pension insurance report this medium-term figure has been lowered from 0.37 percent to 0.2 percent. With regard to the labour force, the assumption made in the 2007 pension insurance report for the year 2008 corresponds with the assumption made by the German Council of Economic Experts (SVR) in its forecast. Against the background of a positive development on the labour market, the 2007 pension insurance report assumes a significant decrease in the number of registered unemployed. In 2008 the number of registered unemployed is reduced to an average of 3.49 million.

13. It is seen with increasingly clarity that the cyclical upswing also has an effect on gross wages and earnings liable for contributions. Therefore in the 2007 pension insurance report the assumption is made that per capita gross wages and earnings grow by 2.4 percent in 2008 in comparison with the year before. The increase is significantly below the 3.5 percent forecast by the German Council of Economic Experts (SVR). For the medium term, an annual increase of 1.9 percent is assumed in the 2007 pension insurance report. This figure is significantly higher than the 1.2 percent increase that was assumed in the previous report.

14. The rise in employment and the correspondingly higher wage and earning sum liable for social insurance contributions is reflected positively in the financial position of the pension insurance. However, the effects cannot be determined precisely in an empirical way as in 2006 the contribution side was biased upwards as a consequence of bringing forward the final payment date of the full social insurance contribution. Because of this a comparison between the income in 2006 and in 2007 is only informative to a limited extent. With this in mind, pension insurance contribution income and total income is likely be lower in 2007 compared to 2006, by 5.6bn and by 4.4bn Euros respectively.

15. It is anticipated that the universal pension insurance will end 2007 with a surplus (income minus expenditures) of about 1.2bn Euros. In contrast to this positive result the 2006 pension

insurance report had anticipated a negative balance of about 3.1bn Euros for 2007. The surplus this year arises mainly from the continuing positive cyclical development, but also partly due to the increase in the contribution rate from 19.5 percent to 19.9 percent from January 1, 2007. The results in the 2007 pension insurance report forecast this positive development in the finances in the pension insurance to continue in subsequent years. According to the 2007 pension insurance report, the yearly surplus continues to show an increase, reaching almost 5.2bn Euros in 2010 before falling to at least about 2.2bn Euros in 2011.

16. The positive financial development in the pension insurance has also an effect on the sustainability reserve (*Nachhaltigkeitsrücklage*). The sustainability reserve is likely to be built up to about 11.5bn Euros in 2007. This corresponds to about 0.72 of one month’s expenditure in the universal pension insurance. According to the projection’s middle variant in the 2007 pension insurance report, in the medium term the sustainability reserve will increase to 25.7bn Euros or 1.52 of one month’s expenditure in 2011. This amounts to 12.5bn Euros more than is projected in the 2006 pension insurance report. If the economic assumptions on which these projections are based apply, the sustainability reserve’s positive development leads to the contribution rate remaining at 19.9 percent until 2010 then being lowered to 19.4 percent in 2011.

17. Contrary to the statements given in the 2006 pension insurance report, a pension increase amounting to 0.54 percent has already taken place in 2007 due to the economic upswing as well as a pension increasing effect of the sustainability factor. According to the medium-term calculations, there will be an annual increase in the current pension value from 2008 to 2011 ranging from about 0.4 to 1.6 percent in the old federal states and from 0.5 to 1.7 percent in the new federal states. Thereby the sustainability factor will show a pension value increasing effect in 2008 and 2009 as well, and only in 2010 and 2011 will there be a dampening effect on the development of the current pension value.

18. The GSAC specifically welcomes the fact that the basic economic assumptions for the medium-term in the 2007 pension insurance report are cautious. Thus, some of the assumptions for 2008 have been pitched below the forecasts made by the German Council of Economic Experts (SVR). Also, in contrast to last year’s report, values for the medium-term assumptions have been lowered. The calculations show that the financial situation in the statutory pension insurance has improved significantly and, from the current point of view, is likely in the medium term to be largely secure.

IV. Statement on the projections until 2021

19. The presentation of the long-term financial trends until 2021 uses the same methodology as in previous years. Three

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assumptions regarding wage development are linked to three assumptions regarding employment development giving nine variants in total. The long-term projections serve as a means to test the influence of changes in the various assumptions made about future economic trends. In effect, they clarify how the finances of the pension insurance system react within particular economic and demographic parameters.

20. The long-term assumptions regarding average annual wage growth rate for the old federal states amount to about 1.5 percent, 2.5 percent and 3.5 percent in the three variants from 2012 to 2021. These figures — understandably — also no longer assume a constant wage growth, but rather the growth rate of wage increases themselves show a steady increase from 2012 to 2020. In the middle variant the growth rate increases from 2.2 in 2012 to 3 percent from 2020 onwards, which results in an average yearly growth rate of 2.5 percent until 2021. For the new federal states, it is assumed that the wage level of the old federal states is achieved by 2030. For this long-term period assuming a wage increase of 3 percent is compatible with the assumptions and results of numerous national and international studies. These are commonly based on an increase in labour productivity and an inflation rate of 1.5 percent.

21. The GSAC points out that these long-term model calculations in the pension insurance report are not prognoses for any future development but should be understood as model calculations.

Nevertheless, against the background of the legally defined contribution rate limits of 20 percent until 2020 and of 22 percent until 2030, and the gross pension level target of a minimum of 46 percent until 2020 and 43 percent until 2030, the long-term calculations have a particular significance. In the event of the contribution rate in the middle variant exceeding the 20 percent limit until 2020 and the 22 percent limit from 2021 onwards respectively, the federal government would have to submit proposals to the legislative bodies to ensure that the contribution rate is kept below the stated limit.

22. According to the 2007 pension insurance report, the model calculation's middle variant, crucial for the contribution rate limit to be met, shows that in 2020 the contribution rate limit of 20.0 percent is adhered to exactly. The 20 percent maximum contribution rate set out in the middle variant for the year 2020 corresponds to the figure given in the 2006 pension insurance report. However, the contribution rate is below the limit in 2020 in three of the model variants. In nearly all variants one can see a reduction of the contribution rate when the sustainability reserve fund has been built up as well as a sharp increase in the contribution rate when the sustainability reserve fund has been used up. Thus following the middle variant the contribution rate drops to 19.4 percent in 2011 and the following year as low as

19.1 percent. Because of the adjustment rule[1] the contribution rate remains unchanged on this level until 2016. When the sustainability reserve fund drops to its minimum value in 2017 the contribution rate increases again, at first moderately to 19.2 percent in 2017, before increasing to 20.0 percent in 2018. The contribution rate remains at this level until 2020, only to increase to 20.2 percent in 2021.

23. If the gross pension level in the statutory pension insurance falls below either the 46 percent figure before 2020 in the middle variant or 43 percent before 2030, the federal government would have to submit proposals to the legislative bodies to ensure this situation is avoided. According to the 2007 pension insurance report's forecasts, the pension level target will be adhered to.

24. Taking the modified protection clause into account — i.e. the omitted pension reductions in 2005 and 2006 are set against the pension increases from 2011 onwards — pensions will increase by about 29 percent until 2021. While in the short term the pension increases are modest, the increase is significant from 2013 onwards. However, the gross pension level declines from 51 percent in 2007 to 46.1 percent in 2021. For 2020 a gross pension level in the statutory pension insurance is shown to be 46.2 percent. Thus in 2020, in to the relevant middle variant, the pension level will not fall short of its target.

[1] Under the adjustment rule (*Verstetigungsregel*) set out in section 158, subsection 1, Social Code, Part VI, the given contribution rate has to be maintained so that the sustainability reserve fund does not fall below the minimum value of 0.2 of one month's expenditure or exceed the maximum value of 1.5 of one month's expenditure forecast for the end of the following year [Translator's explanatory note].

25. With regard to the figures set out for the gross pension level it should be taken into account that the pension level decline is caused by two effects that are not directly influenced by pension policy measures. First, because the German Federal Employment Agency's contribution rate reduction to 3.3 percent is more than the increase in the contribution rate for the long-term care insurance, average gross earnings minus social security contributions increase. Second, because of the increase in the long-term care insurance's contribution rate, which – unlike the employed – pensioners have to pay in full, the gross pension minus social security contributions declines. However, since in periods of a cyclical downturn the German Federal Employment Agency's contribution rate has to be raised, the pension level should increase again.

26. Incidentally, it should be noted that the GSAC recommends that future pension insurance reports should expand the prognosis horizon to 2050.

V. Determining appropriate actuarial deductions in pay-as-you-go pension schemes

27. Actuarial deductions in case of early retirement and bonuses in case of postponed retirement should balance out a personal financial advantage that arises when taking early retirement or the corresponding financial disadvantage caused when retirement is

postponed. For example, if the pension is drawn one year before reaching the normal retirement age the anticipated period of pension payment is lengthened accordingly. Without actuarial deductions the full pension would in practice be paid out for one year longer, which would lead to an additional financial burden for contributors. To avoid this, the actual amount of pension paid is reduced if early retirement is taken so that the current value of the total pension paid is the same as if the pension had been taken at the normal age. If retirement is postponed, additional contributions that mean additional pension entitlements normally have to be taken into account. This is usually irrelevant when calculating the actuarial deductions because of the statutory pension's close relationship with contributions paid (participation equivalence).

28. The level of appropriate actuarial deductions depends in essence on the expected number of pension payments. The longer the pension is expected to be paid out the lower the actuarial deduction can be as the pension payments made ahead of the normal pension age are distributed evenly across the whole duration of the pension since the period over which deductions are made is correspondingly longer. Therefore, for example, actuarial deductions for women could be lower than those for men. However this would contradict the principal of mutual solidarity and the avoidance of creating risk groups within the

social insurance community, which is fundamental to the social insurance system

29. But as the period of pension payments is also dependant on the real retirement age, actuarial deductions can be set at a lower level for a younger individual drawing an early pension than for an older person drawing an early pension. This correlation is accounted for in the current pension law so that until the age of 65 actuarial deductions equivalent to 3.6 percent a year are chargeable. If retirement is postponed, bonuses amounting to 6.0 percent per annum are given. However, this gives only a rough approximation of the actuarial calculation of deductions. The terms “deduction” and “bonus” are defined through the setting of the statutory pension age. From the perspective of the individual insured, actuarial deductions can always be interpreted as bonuses for not taking early retirement and the bonuses can be interpreted as deductions for not postponing retirement.

30. The decisive factor in determining the level of the deductions interpreted as “appropriate” in the actuarial sense is the choice of the discount factor used to calculate the pensions’ present values. The higher the discount rate, the lower the assessment of the value of future cash flows in comparison to current cash flows. With a higher discount factor, there is a heavy weight in favour of pensions drawn early while the scales are tipped against future pension reductions based on the actuarial deductions**.** Consequently the mathematical deduction is higher, the higher

the chosen discount rate**.** Conversely, in case of a smaller discount, a lower deduction is sufficient to balance the pensions' present values between an earlier or later retirement date.

32. On the whole there are two contradictory views on how to determine the discount rate. If the discounting of future payments takes place according to the growth rate of the sum of wages and salaries liable for social security contributions, the chosen retirement age — except for pre-financing effects — has no effect on the level of the contribution rate given correctly calculated deductions. In this respect, the deductions should be seen as having no bearing on the contribution rate. If the discounting takes places with the time preference rate of the insured set above the wage growth rate (approximately the capital market interest rate), the deductions turn out to be higher. Here, future pension reductions are given less weight than the value of the decision not to draw the pension early, which is due to be paid out at once**.** From the individual's perspective, money paid out discounted under the time preference rate is of the same value whatever its distribution over time. Deductions calculated in this way can be labelled as incentive neutral. Because pension payments have the same value whether retirement is taken early or at the normal age, pension law does not give any incentive for early or postponed retirement.

33. These two fundamentally different perspectives often trigger controversial discussions. From an incentive neutral perspective,

contribution rate neutral deductions are too low because they give an incentive to retire early and add an implicit tax burden for continuing to work beyond pensionable age. Conversely, from a contribution rate neutral perspective, incentive neutral deductions are too high. They make pensions paid to early retirees permanently lower by an amount that means the contribution rate can be can be cut in the long term. Equally, postponing retirement results in a permanently higher pension that means the contribution rate has to be increased in the long term. As a result, incentive neutral deductions in case of early retirement lead to a partial shrinkage in the scope of the pay-as-you-go system. Conversely, a rise in the average age of retirement – as currently observed – means an expansion of the pay-as-you-go system and a higher contribution rate in the long term. This is due to the fact that because of avoiding deductions (and also claiming bonuses) the internal return in respect of the additional contributions made to the statutory pension insurance scheme generally corresponds to the capital market rate of interest but the financing has to take place through the pay-as-you-go system.

33. Even in the long term, the rate of return in the statutory pension insurance will remain positive, although the statutory pension insurance will theoretically show a slightly lower rate of return in comparison to capital funded old-age pension provision schemes. In this instance, there is an implicit tax amounting to the difference between the contribution paid to the statutory pension

insurance and the insurance premium paid for a capital funded coverage of longevity risk with both schemes providing the same benefit level. The implicit tax arises because there is no corresponding benefit for this part of the contribution. If contribution rate neutral deductions come into effect, the implicit tax burden on early retirement remains virtually unchanged. To continue working despite the option of early retirement is taxed implicitly in the same way as employment liable for social security contributions is taxed at any age. In contrast, in the case of incentive neutral deductions, the implicit tax drops to zero as soon as it is possible to be in regular receipt of a pension.

34. Taking into account both actuarial aspects as well as contribution rate neutrality, the current deductions in the statutory pension insurance are appropriate. Moreover, trends towards earlier as well as later retirement are mostly irrelevant for the long-term development of the contribution rate. However, in case of a decline in the average retirement age the pre-financing costs due to the immediate shortfall in contributions and the earlier pension payments are taken into account. In contrast – as currently observed – an increase in the average retirement age results in pre-financing profits that are only balanced in the long term by higher pension entitlements. Even though under current pension law deviation from the actual retirement age is generally irrelevant for the statutory pension insurance's financial situation, it affects other national income categories. If employment among

the older labour force increases, there is a general widening of the assessment basis in the other branches of social insurance and taxes. Ultimately, this is positive for the production potential in the whole national economy as the working capacity of the insured is available in the labour market for longer.

VI. Age-based revaluation of earning points

35. On October 26, 2007, the Social Democratic party (SPD) congress agreed on a 9-point programme under the title “Reforms for a social Germany”. The aim of this programme is specifically to increase employment among the older work force. To achieve this, it was suggested, among other things, to mark “insured periods that are attained after the age of 60 with a special earning point value that effectively increases the pension”. This approach should give older employees an additional incentive under pension law to remain in employment or to return to employment. At the same time, this measure should make early retirement less attractive.

36. An argument against this regulation is that it constitutes a break in the principle of participation equivalence (the same relative income position during employment and retirement and with this approximately the same contribution for the same benefit) that is a fundamental principle in the statutory pension insurance. However, even in the current pension law one can find

regulations comparable with this age bonus that are not in accordance with the equivalence principle because of social-political reasons. One example is the higher value placed on contribution periods relating to child-raising: these soften the effects on a pension of lower earnings during child-raising periods. Under these, following the child-raising period of three years, the pension entitlements of parents that come from employment periods on below-average earnings until the child is 10 are revalued when the pension is calculated; a revaluation of earnings liable for contributions by half of 100 percent of the average maximum earnings occurs. And here the question is whether this should apply to older workers in a similar way.

37. Looking at the political aspects of distribution, one has to determine which group would gain from a revaluation of earnings points in old age. In general, employment increases with higher individual qualifications. Differences in employment between groups with different levels of qualification are pronounced. According to a study by the institute for economic research DIW Berlin, based on Mikrozensus (sample census) data for 2004 only 16 percent of those aged 60 to 64 without vocational training and 21 percent of those aged 60 to 64 educated to apprenticeship level were in employment. In contrast, 39 percent with a vocational degree (*Fachhochschule*) and 57 percent with a university degree in this age group were still working. Therefore a revaluation of earned income points for the over-sixties is likely to

benefit those who already have comparatively high pension entitlements already due to having an above average income as well as a continuous career. Furthermore, as regards distribution such a regulation is likely to be problematic as it offers a further advantage to a group that is already favoured by the so-called "regulation 45"[2] in regard to the increase in retirement age limits.

38. It would not be appropriate for the statutory pension insurance to finance this measure since the employment policy target is the primary objective of the bonus for continuing to work in old age. It is more a matter of a non-insured benefits and benefits not covered by contributions respectively that, if they are deemed necessary, should be financed through taxation.

39. The GSAC appreciates the efforts made to increase employment among older people. In particular with regards to demographic development this is a necessary target to consolidate the financing of all social security systems. However, the GSAC holds the view that an increase in employment should be aimed for first and foremost through labour market policy measures and not by additional incentives within the pension insurance. In particular the GSAC questions whether the target group can be reached with a revaluation of earnings points. It sees the danger of undesired distributional effects as it is likely

[2] According to the "regulation 45" (*45er Regelung*) a person can retire at the age of 65 without actuarial deductions when being insured for (at least) 45 years [Translator's explanatory note]

that those who would particularly benefit from the regulation are people who already have above average pension entitlements.

VII. Widening of the scope of insurance liability within the pension insurance scheme

a) Current position

40. Currently in Germany all salaried workers but only certain groups among the self-employed are insured under one of the public compulsory old-age schemes. Thus salaried workers as well as certain categories of the self-employed as defined in Paragraph 2, Social Code Book 6, are covered by the compulsory pension insurance scheme, members of professional associations are covered by their professional pension schemes and farmers by the agricultural pension fund. However, in 2006 the majority of almost 4.4m self-employed were not covered under any public compulsory old-age insurance scheme.

41. Because of the Bismarkian understanding of social insurance this group of self-employed who fall outside the professional associations is unaccounted for within national pension schemes. Other countries that established their social security systems later billed them as universal schemes that are not set up for specific types of employment. According to Bismarkian understanding, the self-employed, unlike salaried workers, do not need the collective protection of mutual support as they are in the position of having

sufficient means to meet their own retirement needs. That is why they should also not enjoy the benefits that came with the introduction of the pay-as-you pension insurance scheme. However as the gradual integration of several groups of the self-employed into the national pension system shows, the assumption that this group does not need protection has been questioned several times in the past. Thus there have been grounds for each widening of the scope of social insurance through particular protection measure to integrate self-employed groups. Therefore those self-employed groups that relied on the earning power of their own labour rather than on owning capital were considered as in particular need of protection. Next to be taken into the national pension system were domestic servants, teachers and others working in education, then craftsmen. From 1957 onwards, work was begun on creating a pension scheme for farmers and the foundation of comprehensive pension schemes for the professional associations and the insurance liability in a public compulsory national system was extended to more groups of the self-employed.

42. Since the beginning of the 1990s the structure of employment in Germany has altered considerably. The boundaries between historically developed forms of work — dependent and independent employment — have become increasingly fluid. The possibility of changing one’s employment status during the course of a working life has increased considerably. And because of this

the number of those engaged in so-called normal employment, regarded as long-standing, continuous, liable for social insurance contributions and securing an acceptable standard of living has declined considerably. Although in 2007 an increase was discernible, the number of employees liable for social security contributions declined from about 29.3m in 1992 to just under 26.4m in 2006. At the same time in the same period, the number of self-employed has grown from 3.5m to just under 4.4m. According to this, the number of those not covered by one of the public statutory compulsory pension schemes should have risen.

43. Not only employment structure but also the structure of the self-employed has changed in the past decade. Thus the increase in the number of self-employed has not taken place among the “classic” self-employed, for example, craftsmen, farmers or members of the professional associations but rather among the so-called “new” self-employed. These in general are dependent on the value of their own labour, own no or only a very small amount of capital and as a rule have no employees. For this reason, they are called one-person-business. While the number of self-employed with employees has remained almost constant since 2000 and stood in 2005 at almost 1.8m, the number of so-called one-person-businesses has grown from 1.8m in 2000 to 2.3m in 2005 and this group is responsible for the increase in the number of self-employed in recent years. This development has

led to the fact that today more than half of the self-employed employ no other person in their businesses.

44. It is especially noticeable that today the income situation in particular reference to one-person-businesses is not significantly different from the situation faced by employees. In 2005 almost 39 percent of white- and blue-collar workers and 37 percent of the almost 2.3m one-person-businesses had an income of under 1,100 Euros while among the self-employed who employed others it was just under 15 percent.

b) Meeting individual needs for insurance protection — missing old-age income and moral hazard.

45. One argument that frequently comes up in the discussion about widening the insurance liability is how to meet the need for protection of the self-employed who lack sufficient insurance. However, the extent to which the self-employed can be seen as in need of protection due to their not being compelled to join the public pension system or rather the extent to which they are able to provide for their old-age themselves has not been conclusively established. The income situation of an increasing number of one-person businesses suggests a limited ability to save and, as a consequence, many of those with one-person businesses are unlikely to have sufficient old-age income at their disposal. As the 2005 AVID survey shows, people with a low old-age income have episodes of self-employment in the course their careers that

amount to almost three times longer than those with higher old-age incomes. This shows that self-employment is related to a higher risk of poverty in old age.

46. At the same time, widening the insurance liability is a significant matter even when set against a background of the need for state-run insurance protection. Both state and tax-payer have to be protected against moral hazard behaviour causing inappropriate claims being made on state benefits. Moral hazard behaviour is seen within the framework of old-age provision if workers alter their behaviour so that they optimize their old-age benefit, which therefore places a burden on tax and contribution payers. For those with lower earnings, this behaviour makes clear economic sense if they can count on means-tested benefits under the basic old-age income support provision or under the basic income support for a reduction in earning capacity.

c) Implicit taxation in the statutory pension insurance scheme

47. The rate of return of a private or an occupational capital funded old-age provision scheme follows the capital market. The rate of return is reduced by administration and management costs. In contrast, the (implicit) rate of return in a pay-as-you-go pension system corresponds, in principle, to the wage sum dynamic, which in turn is defined by the change in per capita salaries and the number of those in employment. Demographic changes are one reason why the rate of return in the statutory

pension insurance scheme is likely to decline and lag behind the rate of return achieved by capital funded old-age pension products. The existing insurance liability means that those covered by the statutory pension insurance scheme miss out on the benefits of relatively higher returns in capital funded old-age pensions. For this reason, the insured view contributions to the statutory pension insurance as divided into two parts: one part leads to a pension benefit corresponding to the capital-market rate of return, while the other part is seen as something on which they receive no return and therefore is regarded as an (implicit) tax.

48. The regulations concerning exceptions in the pension insurance liability lead, as regards the implicit taxation, to a breach of the principle of horizontal taxation justice. According to this principle, all those liable for tax and who have the same level of taxable income should be burdened to an equal extent. But taxation equality is not achieved if only those insured in the statutory pension insurance are subject to this implicit taxation. This horizontal taxation inequality can be countered if the implicit taxation of pension insurance contributions is reduced or eliminated by a higher federal subsidy or if the group of those subject to insurance is widened. In the first case, the group-specific implicit taxation is substituted by a universal explicit tax. In the second case, everyone would be subject to this implicit taxation.

d) Concluding remarks

49. In the short term, extending the financial base of the statutory pension system by widening the scope of compulsory insurance has a positive effect on the financial position of the pension system. However, it should not be overlooked that in the long term the additional contributors are set against a greater number of beneficiaries. According to the current law, a widening of the scope of compulsory insurance would, in the short and medium term, give the potential for a decrease in the contribution rate. Decreases in the contribution rate are based on the fact that these temporary financial improvements will not be used to expand benefits. Consequently, the improvement produced in the financial situation of the statutory pension has a limited duration.

50. The GSAC sees that for an increasing number of workers the risk of being dependent on this basic income support in old-age or when earning capacity is reduced will increase, not least because of the increase of those with interrupted careers, namely the one-person businesses. Increasing poverty in old age leads to an increasing burden being placed on public finances. Set against this background, a part of the GSAC advocates a widening of the scope of insurance liability in the statutory pension insurance to include that group of the self-employed that until now have not been covered by any of the obligatory old-age pension schemes.

51. Another part of the GSAC, while recognising that the need for protection among the self-employed in particular is not being

sufficiently met, stresses the risks relating to widening the scope of the insurance system. Such a widening of the pay-as-you-go system would lead to an improvement in the financial situation in the statutory pension insurance as long as the pension entitlements of those newly covered by compulsory insurance are not fully met. This improvement in the financial status would — these members of the GSAC fear — not be used to decrease the contribution rate but rather to expand current benefits. As a consequence, this would negatively affect the system’s recently established stability. These doubts could be offset by guaranteeing that the additional income generated by the expansion of those subject to compulsory insurance is used to decrease the contribution rate in the statutory pension insurance.

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