Special report of the German Social Advisory Council on the Pension Reform February 13, 2001

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1. Introduction

1.1 Motivation for a special report

1. In its report on the Federal Government's 2000 Pension Insurance Report, the German Social Advisory Council (GSAC) announced its intention to comment in a special report on the draft bill for reform of the statutory pension insurance and on the subsidy of capital-funded old-age provision (Retirement Assets Act, Altersvermögensgesetz – AVmG) in order to contribute to the debate in the legislative bodies in accordance with its statutory duty. In its report of November 23rd, 2000, the GSAC made some preliminary comments on certain aspects of the draft bill.[1] This special report expands on those comments and assesses them in the light of modifications made in the course of the debate.
2. The GSAC considers a special report necessary because of the time that the federal government envisages the reform project will take - the government has stated that it sees the reform taking place over at least a 30-year period. Furthermore, such a reform should be capable of dealing with the challenges that the predicted demographic changes over forthcoming decades will produce. It must, on the one hand, secure the funding of the old-age security system in Germany keeping the statutory pension insurance as its most important pillar for the future generations, on the other hand – it should by means of a supplementary, capital-funded scheme – guarantee a safety net that allows the long-term insured to maintain a standard of living after retirement that approximates to that achieved during their working lives. This special report analyses

whether and to what extent the reform package already passed by the German Bundestag can achieve these aims.

2.2 The need for reform

3. In an early phase, at the end of the 1970s/beginning of the 1980s, the GSAC dealt with the challenges that the predicted future demographic trend would produce for the pension insurance system. In its annual report on the federal government's projections of the current and future financial situation of the pension insurance from February 23rd 1979[2], the GSAC pointed out that for the pension insurance's future development an in-depth analysis of the long-term problems of the old-age security system was essential. At that time, the GSAC assigned a team of researchers to carry out an analysis of the pension insurance's long-term perspectives. On the basis of that team's analysis, the GSAC debated aspects of the pension insurance's long-term development and gave its opinions in a report on the subject to the legislative bodies.[3]

The scope of the problems foreseeable then is shown by the research team's conclusion that – depending on the model variant used – the contribution rate must rise far above 30 percent by 2035 if no counter measures are taken.[4] At that time, the GSAC saw the range of possible solutions within the system as either increasing the contribution rate to

[1] See Bundesrats-Drucksache Nr. 769/00, S. 157, TZ 2.

[2] Report on the calculations of the federal government on the financial situation in the statutory pension insurance (*Gutachten zu den Vorausberechnungen der Bundesregierung über die Entwicklung der Finanzlage der gesetzlichen Rentenversicherung (Rentenanpassungsbericht 1979), Bundestags-Drucksache 8/2709, S. 108).*

[3] The GSAC's report on long-term problems of the old-age security system in the Federal Republic of Germany (*Gutachten des Sozialbeirats über langfristige Probleme der Alterssicherung in der Bundesrepublik Deutschland, Bundestags-Drucksache 9/632*).

[4] *Der Bundesminister für Arbeit und Sozialordnung (Ed.), Langfristige Probleme der Alterssicherung in der Bundesrepublik Deutschland, Band 1, Bonn o.J. (1981), S. 40 ff.*

just under 35 percent to maintain a constant pension level or to reduce the pension level by about half to maintain a constant contribution rate of 18.5 percent; neither option was practicable.

4. The results of the 9th coordinated population projection[5] show the changes in the demographic trend, obvious when one compares the tables shown in graph 1 (see appendix). A comparison between the age structure of the population in Germany in 1910 with the prognosis for 2050 demonstrates this trend most clearly.

5. Two things are striking: while the age structure in 1910 resembles, with only small deviations, a pyramid that narrows relatively evenly towards its apex, i.e. almost every older age-group is followed by a larger younger age-group, the prognosis for 2050 shows a different picture. Up to the 55-year-old group, each younger age-group is smaller than the one above while the upper part of the graph (56 years old and older) mirrors the consequences of the two world wars, ie a fall in the number of births. The declining birth rate is obvious among the under 55- year-old groups. The second distinctive feature is that in 1910 the number of people over 70 is very small while the comparable figure for 2050 remains high and only declines very slowly with increasing age. Here the effects of already much increased and further increasing life expectancy are shown. For both phenomena - a low birth rate accompanied by increasing life expectancy among older generations - political solutions to the question of old-age security provision must be found.

[5] *Statistisches Bundesamt (Ed.), Bevölkerungsentwicklung Deutschlands bis zum Jahr 2050. Ergebnisse der 9. koordinierten Bevölkerungsvorausberechnung, Wiesbaden 2000*

6. At times an increase in the birth rate and/or increased inward migration are offered as solutions to the problems caused by an ageing society. In answer to this it must be pointed out that altering the old-age dependency ratio in the short- and medium term is only possible to a limited extent. Indeed, while it is assumed that the state and in particular the social security systems are able to influence the birth rate they should not sanction individual decisions over whether to have children but should aim to reduce the many material disadvantages faced by families and single mothers.
7. Higher migration numbers do indeed, as seen in tables 1 and 2 (see appendix), affect the old-age dependency ratio trend. But this is noticeable only in the long-term. The advantages for the old-age security system, in the form of a lower old-age dependency ratio and a higher contribution income, are set against exacerbated integration problems. This increase in immigration comes at point in time when it is critical to balance the increasing old-age dependency ratio of the German resident population. Migration would have a slightly rejuvenating effect because the average age of immigrants is about 10 years below the average age of about 40 for the German resident population.
8. Reform measures in the pension insurance system regarding the system's benefits and funding in the past 25 years have had three aims:
    - Numerous measures were taken to either reduce the overall benefit level or to cut some benefits thus limiting the overall level. Such measures were intended either to avoid

increasing the pension insurance’s contribution rate or to at least limit any increase.

- Many of the previous reform measures contained elements to substantially increase entitlements for raising children.
- The third direction – introduced with the 1992 Pension Reform Act and greatly enforced in the second half of the 1990s – was to meet a greater part of the pension insurance's expenditure by means of a federal subsidy financed through taxation. Here it was the case of transferring the equivalent of one tax rate point from sales tax volume (1998), and after 1999 from the ecological tax volume to finance the contribution equivalent paid by the federal government for child raising periods.

In addition, the financial burden to the pension insurance caused by the reunification of Germany also has to be considered. Over time, this burden will diminish.

9. The first two aims are part of the federal government’s current pension reform proposals. Reductions in the general benefit level, which will come into effect only very gradually and over a long period, are contrasted against improved pension entitlements for child raising periods. The latter will be of particular benefit to women.
10. Today the tax-financed element of the pension insurance’s expenditure (see table 3, see appendix) is already so high that a further increase –beyond statutory index-linking is considered impossible. The reasons for this are not wholly fiscal. A further increase would not only bring the danger of a gradual conversion of the insurance system from one characterised by relating benefits

to contributions to one organised as a tax- and transfer system. However, in times when the federal budget requires consolidation it could result in the subsidy being regarded as something that can be altered according to external financial considerations, with the result that confidence in the pension insurance scheme by its members could be undermined.

11. At the heart of the planned reform is the change in the relative importance of the statutory pension insurance as opposed to occupational and private old-age provision. The federal government's reform concept is shaped by the assumption that in the future even the long-term insured will in old-age need to draw on other sources of income besides the statutory pension to maintain the standard of living attained during their working lives. Income drawn from occupational and personal pensions will have to replace some of the money that until now the statutory pension alone provided. Thus, occupational and personal pensions become a partial substitute for rather than an addition to a statutory pension.

2. The elements of the reform: aims, measures, consequences

2.1 Long-term stabilisation of the contribution rates

12. As explained in the preamble to the draft bill for the Retirement Assets Act, the federal government's stated aim for the pension reform is to decrease and in the long term stabilise the contribution rate to the pension insurance scheme. The acknowledgement that the partially funded state pension alone becomes increasingly less able to guarantee an acceptable standard of living gives rise to the

second, qualitatively new, aim that the reform should produce a capital-funded old-age security system covering as many people as possible.

13. As shown in the model calculations available to the GSAC, it is possible – even taking into account modifications made during the legislative process – to achieve the aim of maintaining the contribution rate at or below 22 percent until 2030 (the end of the calculation period) as well as guaranteeing a net pension level above 67 percent. This assumes that the economic and demographic assumptions (see table 4, see appendix) taken for the status-quo-scenario and the reform concept match real future basic conditions.[6] The members of the GSAC differ in their opinion on the validity of those assumptions. In the model calculations, the threshold value of 20 percent until 2020 and the threshold value of 22 percent until 2030 are not exceeded and the net pension level does not fall below 67 percent.

    This is no guarantee that – if the assumptions in the model calculations prove incorrect – other political adjustment measures will not be undertaken that are at present not part of the reform package.

14. In this context, the GSAC's statement on the problems regarding long-term model calculations in its report on the 2000 pension insurance report should be remembered.[7] This statement referred to the 15-years prognoses in the federal government's pension insurance report. For a 30-year forecast period the fact that these calculations can only function as limited prognoses is even more relevant. The validity of underlying economic and socio-

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[6] See *Bundestags-Drucksache* 14/4730, S. 159.
[7] See *Bundestags-Drucksache* 14/4730, S. 158 ff.

demographic assumptions determine the probability of those calculations proving correct. If the model calculations on the pension reform conclude that, for example, a contribution rate of 22 percent is not exceeded in 2030, it does not mean that this will indeed prove to be the case without further measures being taken as necessary. It has to be pointed out that the degree of probability that a certain calculation result will prove correct becomes more uncertain the further into the future the projection is made. Model calculations are therefore not prognoses.

15. The GSAC points out that even in the medium term the two quantitative aims can conflict with each other if economic, demographic or conditions regarding taxes alter. Then future governments have to reassess the trade-off between such aims.

2.2. Building an additional capital-funded old-age security system

16. The reform's innovative element is the introduction and organisation respectively of an additional capital-funded old-age security system. In principle, private saving is subsidised – starting at one percent in 2002 with a target value of four percent up to the corresponding contribution assessment limit (*Beitragsbemessungsgrenze*) in 2008 - allowing €154 per person and €185 per child (entitled to child benefit). An alternative – if it is more favourable – is to allow a tax-free savings sum worth up to four percent of the contribution assessment limit.

17. Federal subsidies to promote saving through the use of additional tax allowances are nothing new in Germany, indeed for many decades it has been a feature of several laws on the accumulation

of capital. The novel feature here is that the approach taken in the draft bill is aimed solely at old-age provision. This becomes apparent with the fact that the period when money is locked up in such a savings instrument is not set at six or seven years as in previous laws on capital accumulation, but in principle lasts until the date of retirement. The accumulated capital is not intended to be available as a lump sum at the end of the contribution period, but used either as a long-term pension or a long-term payment plan. This makes sense because the philosophy behind the reform suggests that such a pension plan should at least compensate for the long-term reduction in benefits that are part of the consolidation measures aimed at stabilising the contribution rate. The GSAC has already commented on the question whether and to what extent it is possible to determine the sum of the whole pension level by adding the level of private old-age provision to the statutory pension insurance level.[8]

18. Whatever the case may be, it can be stated that idea of a federal subsidy for private pension provision has won wide political and public approval. Another undeniable fact is that a sufficiently long savings period and proper use of the federal subsidy makes it possible to achieve a level of benefit that more than compensates for the reduction in that provided through the statutory pension insurance.

    Because of this, old-age provision – when compared with the situation without a reform - has effectively increased without a considerably higher burden being placed on the individual.

19. The GSAC regards the federal subsidy offered at the highest level as generous. As seen in table 5 (see appendix), those on low

[8] See *Bundestags-Drucksache* 14/4730, S. 161.

incomes only have to make a minimal and therefore affordable contribution while making use of the highest subsidy limit. One example shows that the burden on the gross income of a low-income couple with two children afforded through the federal subsidy is between just 0.40 and 1.74 percent. This raises the hope that the take-up of the additional personal old-age pension will be widespread in this income group too.

20. In the unfunded pension system as in the capital-funded supplementary system, the main aim is “material security” ie “income security”. For this reason, not all types of capital accumulation are suitable as pension provision and not every type of savings scheme would count as a capital-funded pension product. The most important requirement for a capital-funded pension product is its ability to guarantee an income for life. Knowing, for example, that while 40 per cent of boys born today will reach the age of 80, but that no individual knows how long he or she will live underlines the importance of such a criterion. Therefore a basic requirement in a capital-funded old-age security system is to protect against the “risk” of longevity by means of a lifelong income in old age. This life-long income should come not only from the yield of capital stock accumulated during a person’s working-life, but also from its release, i.e. capital reduction. Real capital or finance capital that is bequeathed rather than released does not serve as the saver’s old-age provision and is therefore inefficient as regards the specific aim of providing “old-age security”.

21. For this reason it is important to make a government subsidy dependant on whether different types of savings are subject to a

minimum safety level and if the risk of longevity can be safeguarded via a pension or a long-term payment plan.

22. It is open to question whether all 12 requirements in a subsidised old-age provision product mentioned in the “certification law” (*Zertifizierungsgesetz*) are necessary or whether this extensive catalogue of criteria acts as an administrative obstacle. Whatever the case, the GSAC regards the criteria – namely the contribution guarantee, its non-transferability, the fact that it cannot be used as capital to raise money against and the life-long payment of saved contributions intended to provide old-age security – as vital.
23. Anyone who pleads – for good reasons – for deferred taxation of savings intended as old-age provision and who makes use of tax exemptions for savings during working-life has to be prepared to accept taxation of old-age income. As regards residential property, using incentives intended for old-age provision to set against taxes based on its rental value means that the property should be subject to taxation at a later date.
24. Criticism of the German Bundestag’s proposed capital-funded personal pension centred on two aspects: (1) Those on low incomes are unable to afford private provision at the level envisaged; they are particularly dependent on private pensions if in retirement they wish to maintain the standard of living they achieved during their working lives. (2) Private provision is not able to cover 100 percent of those eligible in each category nor can 100 percent of eligible savings be used as part of old-age provision since the scheme is voluntary.
25. Individuals and households on low incomes undoubtedly have more difficulty than other income groups in accumulating savings that can be built up to an appreciable amount to provide old-age

security, yet a substantial subsidy is available particularly to those on below average income – referring again to table 5. Because higher numbers of women are represented in the low income segment they enjoy the government subsidy to a greater extent.

26. In this context one should mention that without any reform measures the contribution rate for the statutory pension insurance would increase even more. This in turn would affect the income of those on low incomes even further. Furthermore, it has to be taken into account that the amount of subsidy is part of the 4 percent of the income (up to the contribution assessment limit) that can be received. Thus the actual reduction in gross income is considerably below this 4 percent. For example, if the maximum amount eligible for subsidy is €600 per annum, given annual earnings of €15000 earned by a single, childless person in 2008, then €446 have to come from the employee's wages, the remaining €154 are covered by the government subsidy. A married couple with two children, also on an income of €15000 has only to contribute €60 from their salaries. The remaining sum up to €600 would come from the government subsidy. Admittedly, it has to be pointed out that other for reasons – an unwillingness to forego consumption now in favour of future provision when, for example old-age is seen as being far in the future, for example – some groups eligible to receive a subsidy still make none or inadequate provision for personal old-age security.

27. The objection that – as already indicated – by introducing a personal capital-funded old-age provision subsidised by the government not all of those who could make use of such a subsidy are reached and therefore the aim of creating comprehensive old-age insurance is missed, must be taken seriously. In this respect, at

present it remains a matter of speculation as to the extent to which the subsidy will be taken up when it reaches its maximum level after 2007 and which categories of people will not participate in the private pension system.

28. The need for standardisation in the contracts of those instruments of old-age provision that are eligible for subsidy is properly dealt with in the draft bill on certification of old-age provision contracts.

29. In the legislative process it was also decided that in future residential property that is for personal use will be eligible for subsidy if the criteria in the draft of the "certification law" are effectively met. This corresponds to the principle of equal treatment.

30. Residential property that is for personal use has been included in the list of types of savings eligible for the government subsidy. This was done because of its popularity as a means of old-age provision among wide sections of the population. Popular support for this method of pension provision justifies subsidising it as a capital-funded old-age provision product but does not mean that the subsidy is given special treatment. The GSAC takes it for granted that the same criteria should be applied to all types of savings for personal old-age provision subsidised under the Retirement Assets Act. Any special treatment of one type of saving would mean discriminating against another. Anyone who regards the fact that once they have paid their mortgage in full, the money that is no longer spent on either mortgage or rent payments can be regarded as a life-long "substitute for old-age income" and who wants to claim the new subsidy, has to accept that the deferred taxation which forms part of the subsidy might affect the rental value or has to accept another form of taxation.

31. Another form of capital-funded pension insurance is the occupational pension scheme. As discussed in the 2000 pension insurance report, as well as the subsidising private pension plans (3rd pillar of old-age security) the GSAC also supports the development of occupational pension schemes (2nd pillar). In this area, the German Bundestag has decided that the subsidy for occupational pensions should no longer be dependent on the 12 criteria used to assess whether a private pension is eligible for government subsidy; these criteria will now be valid only for pension products issued by banks, insurance companies and other financial institutions. The GSAC supports this decision as it means that existing models of occupational pensions can be included under the government subsidy. Moreover, existing types of agreements made on a profession-wide or collective basis are not discriminated against for old-age pensions.

32. At present four types of occupational pension schemes exist: direct insurance (*Direktversicherung*), direct pension promise (*Direktzusage*), *Pensionskasse* and *Unterstützungskasse*. For tax purposes, these four types are treated differently. Since only two of these types are currently eligible for government subsidy, the GSAC welcomes the new type *Pensionskasse* as eligible for subsidy.[9]

33. The GSAC considers that the 2nd pillar should be strengthened. Therefore reform was necessary in order to achieve a three-pillar base on which to build old-age provision. Given that there are several advantages to occupational pension schemes when compared to private pensions and to the benefits offered by the state pension insurance scheme, the development of this pillar

seems sensible. The GSAC points this out in its 2000 pension insurance report.[10]

34. Through the *Pensionskasse*, ways for employees to claim tax relief and government subsidy respectively are set up. There are two methods: employees and employers can either continue with the existing means of subsidy with tax and contribution exemptions (the provision of expenditure from remuneration conversion (*Entgeltumwandlung*) is only true for the transitional period that ends in 2008 during which expenditure is exempted from contributions) or if expenditure is subject to contributions then the subsidy and the deduction for special expenditure can be claimed. The *Pensionskasse* is a vehicle to allow the transfer of entitlements accrued under *Direktzusage* and *Unterstützungskasse* to it without attracting extra tax liability. In this way these two types of occupational pension can also be included in the government subsidy scheme. In the transition period, access to a pension fund is granted via two parallel ways each with differing means of funding. Such a transfer possibility should also be extended to *Pensionskassen*.

35. Because the cost of contributing to a *Pensionskasse* is exempt from tax, the benefits resulting from the *Pensionskasse* are liable to deferred taxation. Since a *Pensionskasse* is similar to a *Pensionsfonds*, contributions to one are also tax free. For the *Direktversicherung* the lump-sum taxation rules set out in Section 40b EStG (income tax law) are applied.

36. These *Pensionsfonds* are characterised by the following properties:

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[9] See glossary in the appendix for an explanation of the different occupational pension schemes.

[10] See *Bundesrats-Drucksache* 769/00, S. 162, TZ 41.

- The funding is capital-covered which means that they are less affected by demographic changes than pay-as-you-go systems.
- The wide choice of investments open to pension funds has given them until now the potential to earn higher rates of return, which has led to the already efficient provision of occupational pension plans to be further increased. It has yet to be seen whether this instrument is compatible with Europe-wide schemes and is able to compete with such schemes.
- Since the funding is external to the company, the control function of the capital market entails another capital allocation.
- Both defined contribution and defined benefit schemes are possible.
- Employee's entitlements are transferable when changing jobs.
- The need for insolvency protection in the case of defined contributions can be based on the wide selection of investment instruments. In case of defined benefits, the decision to include them under insolvency protection depends on the extent to which regulations regarding investment and regarding insurance control for *Pensionskasse* and *Direktversicherung* are relaxed when applied to *Pensionskasse*. Given the wide choice of investment instruments for defined benefit schemes, insolvency protection would seem an inevitable outcome.

37. Entitlement to benefits accrued from an occupational pension exclusively financed by the employer should be retained when contributions have been made for at least five years and the employee is 30 or older on the date employment ends (previously contributions had to be made for 10 years and the employee have reached the age of 35). The new system diminishes the effect of

men and women's different work histories and the resulting lower occupation pension entitlement for women. It therefore improves the position of women employees as regards occupational pensions compared to the current system. A decision taken by the German Bundestag will improve the transfer of entitlements through remuneration conversion if a person changes jobs. Employees should be able to ask the previous employer to transfer the present value of accrued entitlements to the new employer or rather the new employer's agency which provides the pension plan. A condition of this is that the new employer be willing to take on the commitments of the previous employer. The GSAC considers these regulations as appropriate and warranted. However, tax regulations regarding the transfer have yet to be drawn up. The GSAC calls for them to be drawn up.

2.3 Reorganisation of pensions for dependants

38. The federal government's main objective in the suggestions it has made on the reform of the law regarding dependants' pension is to focus pensions for widows and widowers on those whose childcare commitments have meant that they are likely to have a broken work record. Such improvements suggested are set against benefit reductions particularly for those without children. Any changes to the law will happen over a long period to allow a certain level of protection. This is necessary because in making life-long (financial) plans married couples are influenced by current legislation. Changing their long-term "life plan" is likely to be difficult especially given the current position of the labour market.

39. With the pension reform, far-reaching changes in dependents´ pensions, albeit ones that would only be brought into full effect in

the very long-term, were introduced. They affect four areas in particular, namely the quasi abolition of the “small” widow’s pension, a reduction of the ordinary dependant’s pension’s from 60 to 55 percent (although this is partially compensated by benefits given in respect of raising children), an extension of regulations concerning the income liable to assessment for the surviving spouse and the introduction of an option to choose whether a couple wish to jointly give up future entitlement to a dependant’s pension in favour of an equal division of entitlements acquired during married life. This option was modified in the legislative process to make it possible to split pensions only when both spouses have accumulated at least 25 years worth of pension entitlements. This means that unjustified preferential treatment of those who made most of their pension planning outside the pension insurance scheme should be avoided.

40. All these regulations should be applicable to those who married after December 31st, 2001 and to existing marriages where both partners are below 40. The previous legislation ought to continue to apply to current widows and widowers as well as to those married on or before December 31st, 2001 with the proviso that at least one spouse is older than 40.

41. The GSAC does not agree in its assessment of the intended new regulations. In general, it is clear that benefits paid as a dependant’s pension will fall by a substantial amount. At the same time, this benefit reduction is compensated for by a benefit credit in respect of two or more children in the dependant’s pension that is derived from a standard pension. Furthermore, it can be assumed that because of the lengthy transition period, the intended measures will not affect life-term planning in an unacceptable way. This is

equally true for the future biennial limitation of the “small” widow’s pension, the support function of which is in any case doubtful.

42. The planned extension of the "income allowance" to other income types to ensure equality of treatment seems necessary and appropriate. It is unclear whether when income is assessed whether any differentiation will be made between income earned through employment or from rent or lease. The omission in the planned draft bill of an income allowance for government subsidised provision is an incentive for women in particular to invest voluntarily in private pension plans.

43. The intended “freezing” of the amount exempt from assessment when assessing the surviving spouse's income does not affect the support function of the dependants’ pension. Following the draft bill for 2012, a government report plans to look at whether, given the income position of surviving dependants and labour trends for women, putting a rigid limit on the tax-free amount was appropriate. During the debate on the draft bill in the German Bundestag, the “freezing” regulation was modified making the tax-free sum for income allowance purposes to be permanently index-linked in regard to children. This adds to the various regulations intended to be sympathetic to the question of raising children.

2.3. Independent old-age security for women

44. The declared aim of the pension reform is to improve independent old-age security for women. Measures are needed as normally women tend to opt out of the labour market completely or for a certain time after the birth of a child.

45. The draft bill aims to mitigate the particular disadvantages experienced by women in regard to pension provision. It is planned that periods of low income in first 10 years following the birth of a child will be assessed at 50 percent higher, up to the level of general average income. Furthermore, in the case of subsequent children, it is planned to consider periods when no contributions were made as insured periods in order that pensions may be raised. In addition, in this context it has to be pointed out that the overall reductions of the dependant's pensions are set against improvements that, in the case of women who have raised two or more children, result in a higher pension under the new legislation than is the case under the present laws. The GSAC believes on the grounds of distribution politics the decision to add one additional earning point (*Entgeltpunkt*) per child is appropriate. It sees the measure as a continuation of now defunct 1992 instruments that used means-tested pensions to target a specific group, and thus preferential treatment for women with child-raising responsibilities should continue.
46. An argument against this assessment of the measure is the fact that benefit parts of the widow's pension based on raising children may be subject to income allowance limits. Here arguments regarding distribution politics are of greater importance. Ultimately, it is a question of systematic provision and of transferring pension reform measures to other means of old-age security provision in the case of a woman not being able to make use of the child subsidy because her spouse was not a member of the statutory pension insurance scheme.
47. There was some criticism in the run-up to the reform that the planned improvements were "modest". In the GSAC's opinion

such criticism misunderstands the pension insurance: it can be seen only to a limited extent as a redistribution vehicle from employees and contributors to non-active recipients of benefits. One solution could be to find a "contributor" for the sanctioned periods of economic inactivity. For example, since 1999 the government has made contributions for three years to cover periods of child raising. However, it should be taken into account that the federal subsidy that already makes up pension contribution costs is running at such a level as to make it barely feasible, for both fiscal policy and organisational reasons, to increase it further. The GSAC regards the above solution as an acceptable compromise that points in the right direction.

48. In the reform of the dependants' pension and the reform of independent old-age security for women the federal government has taken further steps to improve pension entitlements for women with children. With this, old-age provision gives more consideration than before to the realities of women's lives. On the one hand women are increasingly participating in the labour market, on the other hand they earn fewer pension entitlements due to child raising. Moreover, later on many women come to depend on derived entitlements. Therefore, equal treatment for women and men has yet to be achieved. Given the increasing participation of women in the labour force, the questions raised by women being away from work to have children will affect pension provision less and less. It should also be pointed out that support for raising and educating children is a national task. Therefore, in principle, such support ought to be organised via the national tax- and transfer system.

2.5. The means-tested minimum pension

49. In a special declaration as part of its statement on the 1999 pension insurance report, the GSAC already gave its opinion of the planned concept of the means-tested minimum pension that had already been set out.[11] These plans did not form part of the draft bill. Instead it is planned to limit or rather abolish the right of local authorities who administer the pension to have the right to assess the income of the children of parents aged 65 and over or of parents who are unable to work to determine the level of benefit paid (the recourse right, i.e. *Regress*).

50. The GSAC agrees that this measure is appropriate to fight hidden poverty in old-age. Even though the German Bundestag has introduced a separate benefit law to deal with this, other opinions about how this benefit and `recourse right´ are to be assessed exist.

51. In the run-up to the reform it was alleged by some that the consolidation measures, in particular the planned benefit reductions, will lead to an increase in old-age poverty seen in terms of claims for social security. The GSAC regards this as unlikely. On the one hand a pension entitlement that is below the social security level is not sufficient evidence in itself of old-age poverty; on the other hand, such an argument assumes that in the future the social security entitlements will be linked to wage rises and not to the cost of living, which is likely to have a flatter trend. In addition improvements – even though they will only come into effect in the long-term – for women who have gaps in their work history due to raising children, are part of the reform project. Its aim is to fill

[11] See comment of the GSAC on some reform proposals (*Stellungnahme des Sozialbeirats zu einigen Vorschlägen zur Reform der Alterssicherung in Deutschland, Anlage 3 zum Gutachten des Sozialbeirats zum Rentenversicherungsbericht 1999, Bundesrats-Drucksache 655/99, S. 146 f.*)

these gaps completely or at least partially, thereby reducing the risk of women needed to claim social security. This also applies to the "child element" in the dependant's pension.

2.6. Reorganisation of pensions for reduced earnings capacity

52. Legislation to reform reduced earnings capacity pensions has already been passed by the legislative bodies, partly because of the necessity of bringing this reform into effect by January 1st, 2001 as the 1999 Pension Reform Act stipulated that previous measures in this area had be replaced at the end of 2000 at the latest. As the reform of reduced earnings capacity pensions is part of the whole pension reform concept this issue is addressed here.
53. In the long term, after the reform the current occupational disability pension will disappear. But the transfer period was extended to those now 40 or above in order to preserve confidence in the system. The GSAC regards the abolition of the occupational disability pension as appropriate.
54. Unlike the 1999 Pension Reform Act, reductions in reduced earnings capacity pensions are retained. At the same time, the compensation by means of a full supplementary period (*Zurechnungszeit*) was extended to the age of 60. Finally – and this differs from the original intention of the 1999 Pension Reform Act – insured persons with chronic health problems will continue to receive a full invalidity pension if they are able to work between three and six hours daily, but do not find a part-time job to meet their needs. The so-called "concrete assessment procedure" (*konkrete Betrachtungsweise*) continues to apply.
55. The GSAC regards it as vital that protection in case of invalidity remains part of the benefit spectrum for the pension insurance.

Therefore, invalidity security remains an important element of a mutual statutory pension insurance.

56. New regulations means that, in comparison with the 1999 Pension Reform Act, the pension insurance incurs a certain level of additional expense. This is due to an extension of regulations regarding preserving trust in the system as well as the continuation of the concrete assessment procedure for those able to work between three and six hours a day. The latter can only be justified because of the difficult situation faced by workers with health problems on the part-time labour market. The planned continuation of the concrete assessment procedure in such cases means that the pension insurance continues to bear the labour market risk for the insured. However, it is envisaged that the Federal Employment Office will reimburse the pension insurance for half the cost of paying out reduced earnings capacity pensions attributable to the difficult situation of the labour market. But this obligation to reimburse is limited to the period for which unemployment benefit is claimed. Since the time a reduced earnings capacity pension is drawn is, in general, likely to substantially exceed the maximum length of an unemployment benefit claim, the additional cost to the pension insurance for pensions paid out conditional on the situation of the labour market are only partially compensated. In such a case, the pension entitlement is lower than the unemployment entitlement.

2.7 Omission of the proposed compensation factor and its replacement by a modified adjustment formula

57. After the hearing regarding the government draft bill and after the subsequent debates in the Committee for Labour and Social Affairs

of the German Bundestag, the original proposal of a compensation factor that would reduce the pensions paid out after 2011 in steps of 0.3 per cent until 6 per cent was reached by 2030 was dropped. To achieve the same financial result and therefore, according to the model calculations, guarantee a maximum contribution rate of 22 per cent in 2030, the adjustment formula that was previously planned was modified. Following this, changes in the contribution rate to the pension insurance and, where required, changes in the share of the gross wage paid into the additional old-age provision scheme (*Altersvorsorgeanteil*) will have a stronger influence on the yearly pension adjustment compared with the original adjustment formula. In principle, through this the German Bundestag follows a recommendation made by the Federation of the German Pension Insurance Institutes (*Verband Deutscher Rentenversicherungsträger, VDR*) during hearings on the draft bill. As a result, the pension increase according to the defined reduced wage, grows at a slightly lower rate in comparison with the adjustment formula as shown in the government draft bill.

58. The main result to come from this modification is that in the future equal treatment of new pensions and already existing pensions will be retained. This also means that after 2011 there will be a standardised pension level. By this means, a central criticism of the reform project has been addressed. The GSAC sees it as correct that the agreed compromise guarantees a standardised pension level for new and existing pensions in the future and therefore also in 2030.

59. The new adjustment formula, in effect from 2011 onwards came out of – as the compensation factor did – an income-orientated pension policy; the accumulative yearly reduction of 0.3 per cent

applied to new pensions as well as that produced by the regulation in effect now were derived iteratively from the politically targeted 22 per cent maximum contribution rate in 2030.

60. In the political debates that led to the compensation factor being dropped and to the modification of the adjustment formula, the pension level aimed at for 2030 has played a central role since the draft bill contained a clause guaranteeing the pension level. Under this clause, the federal government has to submit proposals to the legislative bodies if it seems that the pension level is likely to fall below the minimum value of 64 per cent in the long-term model calculations. This minimum value was increased to 67 per cent after a resolution made by the German Bundestag on January 26th, 2001.

61. The pension level is defined as the ratio of the standard pension and the net average wage. A standard pension is based on 45 insured years for which the average wage was earned each year. The net wage is determined by the Federal Statistical Office following the rules on national accounting. The details given by employers regarding the analysis of the income tax cards available to them are taken as a basis.

62. The GSAC regards the notion of the "pension level" as having a limited meaning. A person's pension entitlements do not only depend on the length of insurance and, in the case of early or deferred retirement, the age of the insured person but also on how the income from which contributions are made changes over time. For an initial calculation of pension entitlement all years of work or rather of insurance history are taken into account and have equal weight. Because the pension level is standardised to the average wage, the actual amount of pension and therefore a possible

provision gap measured against the final salary is hidden when the "pension level" measure is applied if – as it is often the case for employees – salary increases until the age of retirement. On the other hand, for those insured whose salary in the years prior to retirement has decreased – e.g. people in partial retirement – the pension level shows too high an income replacement ratio. To this one should add the influence of progressive taxation on wage and other incomes. An insured income above the average pay leads to a higher "individualised" pension level as a consequence of the progressively higher taxation and vice versa.

63. Setting the pension level at 67 per cent, relatively close to the current value of 70 per cent, could force the federal government into action as external influences came into play. Because of the delayed pension adjustment to the wage trend by about one year, typically the pension level is high during an economic slowdown with its correspondingly low rate of wage rises. In case of an economic boom that brings a correspondingly high rate of wage increases, typically the pension level is low.

2.8 New adjustment formulas and the convergence process in former East Germany

64. The draft bills on the pension reform do not contain any regulations specifically aimed at the states of former East Germany. The federal government's approach that as circumstances in East and West converge further, wage trends and therefore the pension values will also converge has not changed. In any case, the new pension adjustment formula will have a considerable effect on the length of the convergence process.

65. On July 1st, 1999 the ratio of current pension values in East and West was about 87 per cent; according to national accounting, the ratio of the net wages was 83 per cent, ie a similar amount. Whereas the ratio of the gross wages was only about 73 per cent following national accounting.

66. To reach wage convergence at some as yet unspecified point in the future, net wages in former East Germany have to increase by about 17 percentage points more than in former West Germany, the gross wages by about 24 percentage points. Because the pension value in the East is only about 13 per cent lower than the pension value in the West it becomes obvious that even with a pension adjustment following the net formula that was in use until 1999 a convergence of net wages does not automatically result in a convergence of current pension values.

67. At first sight an increase of gross wages of about 24 percentage points does not correspond to an increase in net wages of about 17 percentage points. The net wage is calculated according to the national accounting rules from the gross wage minus social insurance contributions paid by the employees, the share subsidised by the government paid into an additional old-age provision scheme ("old-age provision savings") and minus income tax. The social insurance contributions are already almost equal in former West and East Germany, only the health insurance contributions in the states of former East Germany are higher by a few tenths of a percentage point. Between 2003 and 2010 pension savings are deducted from the pension adjustment in eight steps beginning from 0.5 up to 4 per cent. In model calculations for the years 1999 to 2030 for the states of former West Germany, a moderate increase in the wage tax ratio from 20.51 to 22.19 per cent is

assumed. In the states of former East Germany, this ratio increases from 13.63 per cent to 22.19 per cent in the same time period. The wage tax' progression slows down considerably the net wage increase in comparison with the gross wage increase.

68. With a pure net-wage related pension adjustment, this mechanism has a dampening effect on the parallel increase in pension values. Therefore, the ratios of net wages and therefore the ratios of the current pension values increase to a lesser extent than the ratios of the gross wages. If this dampening element is removed from the adjustment formula – as it was done in the draft bill – the ratio of the pension values increases in line with the ratio of the gross wages. Contributions to old-age provision do not influence this since they are equal in former West and former East Germany. The higher gross wage increase (until reaching complete convergence at 24 percentage points as mentioned above) in former East Germany has therefore a full effect on the pension adjustment and offers a considerably earlier convergence of pensions than would be the case with the previous net adjustment formula.

Excursus:

This can be described in the following calculations:

Net adjustment:

$$\text{Adjustment} = \frac{\text{gross wage (previous year)}}{\text{gross wage (of the year before last)}} \text{ x } \frac{\text{net ratio (previous year)}}{\text{net ratio (of the year before last)}} \text{ x } \frac{\text{KVdR} + \text{PVdR (previous year)}}{\text{KVdR} + \text{PVdR (previous year)}}$$

For a better overview here it is assumed that the changes in contributions to the pensioners' health insurance (KVdR) and to the pensioner' long-term care insurance (PVdR) do not play a role. The formula above can then be written as:

$$\text{Adjustment} = \text{Changes Gross} \times \text{Changes Net Ratio}$$

Forming the ratio of the convergences East to West we have:

$$\frac{\text{Adjustment East}}{\text{Adjustment West}} = \frac{\text{Changes Gross East}}{\text{Changes Gross West}} \text{ x } \frac{\text{Changes Net Ratio Ost}}{\text{Changes Net Ratio West}}$$

In the case of the net ratio East declining more than the net ratio West, the last term in the above formula has to be on average smaller than 1. In this case the ratio of the adjustments East to West are smaller than the ratio of the gross wage trend East to West.

Modified adjustment after the pension reform

In the new adjustment formula, in addition to the gross wage trend only the contributions to old-age security matter. But these are equal in East and West and therefore do not play a role when calculating the ratio of the adjustments East to West. Thus:

$$\frac{\text{Adjustment East}}{\text{Adjustment West}} = \frac{\text{Changes Gross East}}{\text{Changes Gross West}}$$

Ratio of Net Adjustment to the new pension formula:

$$\frac{\dfrac{\text{Adjustment East (net)}}{\text{Adjustment West (net)}}}{\dfrac{\text{Adjustment East (new formula)}}{\text{Adjustment West (new formula)}}} = \frac{\dfrac{\text{Changes Gross East}}{\text{Changes Gross West}} \, x \, \dfrac{\text{Changes net ratio East}}{\text{Changes net ratio West}}}{\dfrac{\text{Changes Gross East}}{\text{Changes Gross West}}} =$$

$$= \frac{\text{Changes net ratio East}}{\text{Changes net ratio West}}$$

Because of the higher increase of the wage tax ratio in former East Germany with a lower initial value this term is on average smaller than 1.

69. In the previous discussion about the pension reform, the East-West aspects of it took backseat a because all participants assume that in the long term the convergence process between East and West will be complete. The GSAC would welcome any measures by which the new pension formula can accelerate the process.

2.9 Intergenerational distribution effects of the pension reform

70. A calculation of “rates of return” is a useful means of measuring the intergenerational distribution effects of an old-age security system or a reform. Here for this purpose – based on calculations

by the German Bundesbank – for birth cohorts 1940 to 2015 the corresponding future pension payments are compared with contribution payments. It is then possible to interpret the actuarial return of this series of payments as a “rate of return” of old-age provision. The calculations are based on a “typical” pensioner, the so-called standard pensioner who as an average earner has paid contributions for 45 years, draws his pension for 15 years and whose widow receives a dependant’s pension for 5 years. The latter is not reduced by allowing for other income. Following the new concept of provision, a dependant’s children have the effect of raising a pension; in the calculations here two children are assumed.

To calculate the total rate of return it is assumed that, in the case of reform, contributions for the additional old-age provision amounting to 1 per cent of average wage are paid according to the subsidy plan for the first time in 2002. These contributions rise in a two-year-rhythm to 4 per cent in the year 2008. To calculate the rate of return, the sum of contributions to the statutory pension insurance and private additional old-age provision is set against the sum of the pension benefits from both schemes. Without the reform, the contribution rate to the statutory pension insurance had to rise faster. To be able to compare this case with the reform alternative, it is assumed that the difference between total contribution rate (i.e. to both the statutory pension scheme and the private additional pension scheme) in the case of reform, and contribution rate solely to the pay-as-you-go system without the reform, is also saved for the personal old-age provision. Then both variants with and without reform differ mainly in regard to the ratio between pay-as-you-go financing and capital funding. The real current yield for bonds is estimated by taking past returns on additional pension provision; for the future a real rate of return of 3 per cent is taken. For the trend of real wages, the known past values are taken; for future values, the calculation is based on an annual rate of increase of 1.5 per cent.

71. In addition to the values of past periods, the assumptions used for calculations for the draft bill of the Retirement Assets Act (*Altersvermögensgesetz*) are taken as a basis for data. In particular, information about the development of the contribution rate and the net standard pension level used to calculate the gross standard pension level were needed. With these, two values which both refer to the gross wage of the average earner were available.

72. Calculations for the "typical pensioner" show that the reform mitigates to a considerable degree the decline of the rate of return conditional on demographic changes. The costs that are inevitable with a (partial) transition from pay-as-you-go financing to capital funding are borne by older generations, who enjoy a relatively more favourable rate of return. Overall, the reform leads to a more equal distribution of the financial burden between the generations.

73. The calculations show that the "total rate of return" is higher for the younger generation under the reform compared with the position without the reform. In the long term, the rate of return improves by about 18 basis points. The capital-funded additional old-age provision scheme has an increasingly positive effect on the rate of return for the younger generations. In contrast, the rate of return is lower for those born before the mid-1970s (see appendix, graphs 2 and 3).

2.10 Financial effects of the reform

74. The starting point for the calculations in the financial part of the statements for the draft bill of a Retirement Assets Act is the current law, but without the "demographic factor" of the 1999 Pension Reform Act. However, it does include the measures in the law to reform the pension of reduced earnings capacities that have a financial bearing.

75. The following measures in the reform package have particular financial effects:

- The return to the wage-related pension adjustment (after a one-off adjustment with the inflation rate),
- The subsidisation of additional personal old-age provision,
- Reform of the dependant's pension and the extension of child-related pension benefits,
- Prevention of hidden old-age poverty.

76. Following the financial part of the statements for the draft bill for a Retirement Assets Act, it was assumed that the newly designed adjustment formulas will lead to benefit reductions of about 5 per cent and a reduction in the contribution rate of 1.0 (1.4) per cent until the year 2010 (2030) compared with the situation without the reform.

77. The new pension adjustment formula applicable from 2011 onwards has always a slowing down effect on pension adjustments and therefore on the development of the contribution rate in the case of an earlier contribution rate increase. According to the new wage-related adjustment formula applicable from July 1st, 2001, the annual adjustment adapts to the gross wage increase of the previous year in comparison with the year before that. If the

contribution rate to the pension insurance or the share of the gross wage paid into the additional old-age provision scheme has altered in the previous year, these changes are taken into account when determining the gross wage increase and thus any change to the adjustment. According to the pension adjustment formula applicable from 2011 onwards[12], the basis value, which is reduced by the share of the gross wage paid into the additional old-age provision scheme and the contribution rate to the pension insurance, is lowered from 100 to 90.[13] This measure must necessarily increase the slowdown effect of rising contribution rates on the size of the pension. As an example, the adjustment rate following the formula in the government draft bill is, all other things being equal, 2.87 per cent assuming an increase in the contribution rate in the previous year from 19.5 to 19.6 per cent and an increase in the gross wage of 3 per cent whereas this adjustment rate would be 2,85 per cent if adjustment formula passed by the German Bundestag was used.

78. Between 2003 and 2010 the inclusion of the old-age provision share in the adjustment formula comes to have a financial bearing

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[12] The formula in the draft bill is:

$$AR_t = AR_{t-1} \cdot \frac{BE_{t-1}}{BE_{t-2}} \cdot \frac{96\% - RVB_{t-1}}{96\% - RVB_{t-2}}$$

with

- AR_t = new current pension value which is to be determined
- AR_{t-1} = current pension value in effect
- BE_{t-1} = average gross wage earned during the last year (if t=current year)
- BE_{t-2} = average gross wage earned during the year before last year
- RVB_{t-1} = pension insurance contribution rate of the last year
- RVB_{t-2} = pension insurance contribution rate of the year before last year

[13] Following the decision of the German Bundestag from January 26th, 2001 the formula is:

$AR_t = AR_{t-1} \cdot \frac{BE_{t-1}}{BE_{t-2}} \cdot \frac{90\% - AVA_{2009} - RVB_{t-1}}{90\% - AVA_{2009} - RVB_{t-2}}$. With AVA_{2009} as the share paid into additional old-age provision in the year 2009 amounting to 4 percent; for the description of the other terms see footnote above.

on the pension insurance since the adjustment rates turn out to be lower by about 0.6 percentage points. The cumulative effect over eight years has a corresponding base effect on the development of the total expenditure volume, in as far as its level is lowered; i.e. increases in expenditure, e.g. because of the pension adjustment, have a lower base as a starting point in the future.

79. Subsidising private old-age provision puts a financial burden on the public budgets via reductions in income tax revenues of about 20 billion DM a year from 2008 onwards. Reduction in expenditure due to the fact that the general federal subsidy (*Bundeszuschuss*) is linked to changes in the contribution rate in addition to its relation to the wage development is set against this. Achieving its aim of "a contribution rate as low as possible and stabilised on a low level" has a positive financial effect on the federal budget - it would result in savings equal to about 12 billion DM in 2030. The fact that the contributions for child-raising periods paid by the government increase to a lesser extent than without the reform also has a financial bearing on the federal budget. Corresponding reductions in expenditures amount to about 3 billion DM for the year 2030.

80. The reform of the dependant's pension until 2030 plays only a minor financial role on the federal budget as regulations ensuring protection of confidence are very strong in this area ie the old regulations continue to apply for an existing marriage where one partner is over 40. Even after 2030 only minor effects on the contribution rate can be expected as the model is designed to be cost neutral.

81. Additional expenditure for local authorities and therefore possibly for individual federal states (*Länder*) would occur if the regulations regarding recourse to social security by older people and those

permanently unable to work do, as planned, relieve the children of such claimants of any financial liability for their care. In such cases, the government compensates the *Länder* for the costs to the local authorities. This is recompensed via a corresponding decline of the income drawn from the ecological tax (*Erhöhungsbetrag*) of the additional federal subsidy. The additional expenditure for local authorities amounts to 600 million DM per year.

3. Additional measures

3.1 Improvement of the information service

82. The draft bill requires that in future the pension insurance institutes must inform the insured on a regular basis about their individual pension entitlements and of the corresponding level of expected pension. The GSAC welcomes this attempt to increase transparency regarding expected pension benefits. This also meets the aim of increasing personal responsibility for individual old-age provision from an early age.
83. However, it is true that complying with the requirement to provide more information means a substantial additional administrative burden for the pension insurance institutes. For example, to provide the new information the Federal Insurance Institution for Salaried Employees (*Bundesversicherung für Angestellte*) would have to send out 80,000 letters each working day. Given this, it would be appropriate to send such letters to be sent every third year rather than once a year.
84. A requirement from private pension providers to supply similar information is welcomed. It remains to be seen how the certified financial services market will react. Moreover, it is also important to consider how information on future private pension benefits can

be compared with that supplied by the pension insurance. Here for instance it should be pointed out that the pension insurance scheme also insures against the risks of being unable to work and (through the dependant's pension) against death. But such services are not among the criteria that must be met to make a private pension eligible for the government subsidy for additional personal old-age provision.

3.2 Harmonisation of the pension system and a system compatible application of the reform measures as regards civil service pensions

85. In its report on the federal government's 2000 Pension Insurance Report, the GSAC gave an opinion on the subject of a possible application of the pension reform's measures for other old-age security systems. At that time, it concluded that applying the reform to all old-age security systems either fully or partially state financed is necessary to harmonise those pensions in a system compatible way. This is equally necessary for fiscal reasons as well as for reasons of social coherence.
    The GSAC again underlines its support for such a position.

4. Recommendations

86. The trend towards an ageing population due to demographic changes is largely irreversible; equally unavoidable is increased cost of old-age security provision that this entails. This rise in the cost of old-age security provision is very real and not something that reform can eliminate. In an ageing population, pension policy can only attempt to spread costs in a way that makes economic sense, is socially balanced and just for all generations. Each

pension reform is always a compromise between various, and sometimes conflicting, aims: ensuring that the reform is financially viable, is efficient in regard to employment and economic growth, guarantees old-age provision, and addresses the issues of promoting social balance and generational justice. Despite its differences over the scope of the reform, the GSAC regards the structural changes made by pension reform as a forward-looking compromise between conflicting pension policy aims intended to achieve economic sense and social balance.

87. The contribution targets should – as is shown – be met through a package that includes other measures. This means that individual measures should not be uncoupled from the whole package during the further legislative process in order that the overall aim is met unless other measures that have the same financial bearing are substituted. Whether the desired aims can be met permanently through the measures set out in the reform package depends fundamentally on the extent to which actual future economic and demographic trends correspond to the framework assumed in the model calculations. Despite these uncertainties, the new adjustment formulas should be sufficient to stabilise the contribution rate at below 20 per cent until well into the next decade. Moreover, disregarding the effects of any possible changes in the tax law that could increase the net wage and lower the pension level, the predicted contribution rate should not conflict with guaranteeing a minimum pension level of 67 per cent.

88. The measures aimed at limiting the growth of expenditure in the statutory pension insurance go hand-in-hand with a novel vehicle, namely the government subsidised private old-age provision. The concept of voluntary membership of any additional private pension

provision, which was set out by the federal government, was approved by the German Bundestag. The government subsidy, which is particularly generous for those on lower incomes, is a necessary stimulant to a high up-take of such instruments by as wide a section of the population as possible. The construction of this new instrument suggests that it will prove popular. This is also true for the occupational old-age provision.

89. In coming years it will be necessary to see whether any possible deficiencies come to light and in what areas they appear. This is particularly important as regards to the up-take of the subsidy for additional private pensions and the extent to which different income groups make use of it.

90. The reform could have suggested raising the retirement age as a way of moderating the increase in the contribution; however the federal government did not submit any proposals on this subject. If in the future it becomes apparent that the measures taken now are insufficient to achieve the political desire of limiting, or even reducing, the increase in the contribution rate, a possible alternative would be to raise the retirement age. If that were to happen, the average length of time a pension is drawn would either be the same as under the status quo or would decrease, which would have a financial effect on the pension insurance. If the length of time a pension is drawn is not decreased, i.e. the person insured retires early, the reductions of the pension amount that apply in case of early retirement, also have an effect on the pension insurance's finance.

91. The increased need for intergenerational redistribution caused by an ageing population is likely to be best met under conditions of strong economic growth with their positive effects on employment

rates. This need for redistribution can be reduced if the government can extend working life and thus reduce the time a pension is drawn. In this case, the transfer income is substituted for earned income. Against this background, the GSAC advises that the foundations be laid for raising the retirement age. The areas to be addressed are taxation and pension regulation, union wage-negotiating policy, education policy, and the organisation of work places. Provided that there are sufficient jobs suitable for older age groups, an increase in the retirement age is a very efficient measure to slow the contribution rate's dynamic down.

92. If the retirement age were raised by a year from the current age of 65, the model calculations done by the Federation of the German Pension Insurance Institutes show a reduction in the contribution rate of 0.8 percentage points. The reduction would be higher if a package of measures dealing with education policies, organisation of work places and collective bargaining, pension and tax regulations was worked out that would help to raise the actual retirement age. At present this stands at 62.5 in former West Germany and 60.7 in former East Germany in respect of old-age pensions giving an overall average of 62 years. Taking into account pensions drawn in respect of reduced earnings capacity, the average effective average retirement age is 60.5 in former West Germany and 58.4 in former East Germany, giving an overall age of 60.1. Taking the available data on new pensioners in 1997 as a basis for calculation, the relief in the medium-term would amount to about 24 billion DM or 1.3 contribution rate points if all old-age pensions were drawn a year later than the current assumptions for new pensions show.

93. A reduction in the time spent in education is urgently needed to improve competitiveness. But the extension of working life that would accompany this leads to an increase in pension entitlements. Thus, if the retirement age remains as it is, the expenses of the pension insurance will as a consequence increase. Extending working life thus leads to a change in the contribution rate if it is accompanied by the pension being drawn later and thus reducing the time pensions are paid out.

94. A possible alternative action would be to raise the old-age provision rate (*Altersvorsorgesatz*) which is currently intended at a maximum of 4 per cent of earnings subject to insurance contributions up to the contribution assessment limit. This measure would have an immediate effect, rather than the gradual one afforded by raising the retirement age would have – via the adjustment mechanism on the finances – but would involve additional expenditures for the government subsidy.

95. Regrettably no measures to introduce deferred taxation (*nachgelagerte Besteuerung*) for old-age income were introduced in the current reform project. The GSAC sees the early introduction of deferred taxation (i.e. making contributions to the pension insurance tax-exempt and pension benefits fully taxable) as the correct solution to the problem of unequal tax treatment of old-age income, something than has been a problem for years. This omission must be seen in the context of a long-awaited and over-due judgment from the Federal Institutional Court on the taxation of old-age income. But in the GSAC's opinion it would not have been appropriate to leave the reform project until the Federal Institutional Court has made its judgment; even more so since the new adjustment formulas – in contrast to the previous net

adjustment of pensions – are compatible with contributions being tax exempt. The new formulas mean that modifications in tax regulations have no influence on pension adjustment.

96. Deferred taxation would also remove one current unsatisfactory tax situation: namely that it is planned to make voluntary contributions to private pensions tax exempt up to 4 per cent of the contribution assessment limit whereas mandatory contributions to the statutory pension insurance are partially paid out of taxed income. This discriminates the statutory pension insurance compared with private old-age provision. Likewise, the current taxation of just the profit share of a pension (*Ertragsanteilsbesteuerung*) discriminates against other types of old-age income. Much as the GSAC argues for an early introduction of deferred taxation – of all types of old-age income if possible – it emphasises that for the benefit of a long-term life-long planning the concerns about protection of confidence have to be met.

Berlin, February 2nd, 2001