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INERTIA CREEPS: REFORMING THE GERMAN PUBLIC PENSION SYSTEM

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"The pensions are secure", the German people heard throughout the 1980s and 1990s from the then Federal Minister of Labour, Norbert Blüm. The slogan sums up the placid approach of German politicians to the "ticking bomb" of demographic change and its effect on the public pension system.

Forty years ago, just 17 percent of Germans were aged 60 or older. Today, the proportion is 23 percent. Forty years from now, 40 percent of Germans will be 60 or over. Germany's PAYGO (pay-as-you-go) pension system is already feeling the pressure of this unprecedented demographic revolution. Contribution rates have risen significantly, but the system remains in deficit, requiring ongoing government subsidies.

The challenge to policy makers is exacerbated by the fact that German elders are highly dependant on the public pension system. In contrast to the English-speaking world, a large part of the population derives most retirement income from the public pension system, and savings in private pensions or personal savings plans are fairly insignificant.

Slowly but surely awareness has grown of the unsustainability of the current system. Several minor reforms were introduced in the 1990s, focussing on a financial consolidation of the system. Then, in 2001, for the first time in modern Germany, the government acknowledged that the current pension system would not be able to provide for sufficient retirement income and that it is an individual's responsibility to close the gaps caused by the predicted sinking of public benefits.

Parliament passed a major reform that scales back future public pension benefits while encouraging the development of private funded alternatives. The private funded pensions, "Riester-Rente" (Riester-Pensions), named after then Minister of Labour, Walter Riester, has been heralded as a major change of paradigm. However, most commentators agree that this reform can only be seen as a first step.

This article gives an overview of the German pension system, its main flaws and the current direction of the reform process.

The Public Pension System

The German pension system is supposed to be based on three pillars: statutory pension insurance, occupational pension plans and private provision for retirement. In reality, statutory pension insurance is by far the most important pillar, representing over 60 percent of an average retiree's income. In contrast to the English speaking world, the share accounted for by occupational pension schemes is only a small part of old-age incomes[1], but roughly one-third of income stems from voluntary private savings and investments. The following analysis relates to the first pillar.

Statutory pension insurance has been the basis of old-age provision in Germany since 1889, when it was introduced by Chancellor Otto von Bismarck as the world's first formal pension system. The retirement and disability insurance started as a fully funded system with a mandatory retirement age of 70 when male life expectancy at birth was around 45 years. Equal contributions by employees and employers plus a state subsidy were paid into a personal pensions account. The pensions that were eventually paid out were modest in comparison to today's and usually weren't sufficient to provide a means of existence.

The first big change to the system was made after two World Wars and the Great Depression had left huge gaps in the funded system. On the one

1 Up to the reforms of 2001, occupational pensions were mainly an instrument of human resource policy in order to recruit, motivate and tie employees and thus supplemented first-pillar pensions.

hand, the number of persons contributing sunk due to the wars, whilst the pensions of a rising number of widows and disabled persons had to be paid. On the other hand, galloping inflation had greatly decreased the value of the accumulated funds that were invested mostly in bonds.

Therefore, in 1957 the system converted to today's pay-as-you-go-scheme. In an environment of nearly full employment this model seemed attractive, because payments to pensioners could begin immediately. At the same time the system became more generous, ensuring that pensions were high enough to guarantee a fair standard of living during retirement. Other changes introduced in 1957 included a lowering of the official retirement age to 65 and the equal treatment of workers and employees.

The German pension system is based on the "contract between generations" under which the active wage-earning population finances the pensions of their parents. As they age, they will then become dependent on the next generation, and so on. By definition, the PAYGO system has no capital base to match pension liabilities. However, a 'fluctuation reserve' is maintained to prevent temporary cash-flow problems. At the beginning of this decade the reserve represented only 14 days pensions.

Pensions are strictly work-related. The level of an individual's old-age income is calculated on a lifetime basis and adjusted according to the type of pension and the retirement age. It is the product of four elements:

1. the employee's relative earnings position;
2. the years of service life;
3. adjustment factors for pension type (normal, flexible, women, disabled or unemployment) and retirement age; and
4. a reference pension value, which is indexed to the annual changes in the level of wages and salaries to enable pensioners to share in rising prosperity.

Apart from old-age pensions the German system provides disability benefits for workers below the age of 60 that are converted to old-age pensions upon reaching 65. Survivor benefits are paid to widows and children.

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The advantage of the German system is the maintenance of a certain standard of living for the pensioners. The disadvantage is the great dependency on employment and the danger of poverty during retirement for persons with an irregular and a short history of employment during their working-life[2]. In a broader European perspective, the German model with its low redistributive effect is classified as a conservative Bismarckian system as opposed to the Scandinavian welfare-orientated Social-Democratic model or the liberal Beveridgian type of Great Britain (Schmid 2002, p 19).

Participation in the statutory pension scheme is obligatory for virtually all employees. The self-employed have the option of joining voluntarily. Civil servants are excluded from the statutory pension plan and have their own, even more generous pension system, which is financed exclusively through general revenues.

Roughly two-thirds of the public pension system's budget is financed by contributions that are administered like a payroll tax. The current contribution rate is 19.5 percent of gross income and is capped at a monthly salary of 5,150 Euro ("upper earnings threshold"), meaning a person earning 15,000 Euro a month contributes no more than someone earning 5,150 Euro. Half of the amount is paid by the employee, the other half by the employer. Contribution rates have been rising steadily since the late 1960s.

The remaining third of the budget is paid via earmarked indirect taxes (a fixed fraction of the value-added tax and the new "eco-tax" on energy consumption) and a subsidy from the federal government. In 2000 this subsidy hit 50 billion Euro. This was the largest single item in the government budget, totaling 20.2 percent of all spending. Altogether, in 2000, public pension costs amounted to 200 billion Euro or nearly 12 percent of GDP. If benefits were financed entirely by payroll taxes, the contribution rate would rise to around 27 percent.

2 Among the 18 traditional OECD member countries, until pension reform in 2001 only Germany had no special minimum protection scheme for the elderly. Persons without sufficient insurance claims were referred to the tax-funded social assistance scheme.

Pensions are computed on a lifetime basis according to the four factors mentioned above. They are essentially tax-free. Pensioners do not pay contributions to the pension system or to unemployment insurance. However, pensioners have to pay the equivalent of the employees' contribution to the mandatory health and long-term care insurance. The equivalent of the employers' contribution to health insurance is paid by the pension system.

Under the original system design, employees were able to draw their standard pension only after 45 years of contributions at an age of 65. Their income would then be approximately 70 percent of the last net income, which amounts to an average pension of 1,200 Euro a month in 2004.

However, a number of generous amendments introduced to the pension system at the end of a long period of high growth and full employment in 1972 made it much easier to retire earlier and still enjoy a relatively high income. In addition, the definition of disability was broadened, simplifying the claim of benefits. Pre-retirement (i.e., retirement before age 60) was made possible through several mechanisms using the public transfer system, mainly unemployment compensation. Due to these changes, by the late 1990s only about 20 percent of all entrants used the "normal" pathway of an old-age pension at age 65; the most popular age to retire was 60. In 1998, the average retirement age in Western Germany was 59.7 for men and 60.7 for women (Börsch-Supan 2003: 17). As in most developed countries, German workers retire earlier than 50 years ago, even though they are likely to enjoy a longer life than their grandparents.

The generosity of the public pension system also helps explain why Germans rely so much less on private pensions than people in English-speaking countries, Switzerland or the Netherlands. In 2000, in the latter two countries, private pension assets represent more than 100 percent of GDP, whereas in Germany they amounted to just 15 percent.

Even though a big part of savings are earmarked for retirement, these contributions cannot compare to the extent of private pension plans in other countries. The statutory pension system still provides for the major part of most retirees' incomes. The above-mentioned average of over 60

percent is slightly misleading as the figure is distorted by wealthier pensioners, of which Germany like every industrialized nation has its fair share. In the middle quintile of income, public benefits contribute an extraordinary 84 percent of pre-retirement income, the highest share of any developed country (Jackson 2003: 14). For comparison, the average worker in Australia receives only 25 per cent of income from the public pension.

The Demographic Trap

The German pension system has worked well for many decades and is still considered a great social achievement, but it is under increasing pressure. The reasons for this are mainly demographic developments. All industrialized nations are aging fast, but Germany will experience a particularly drastic change in the age structure of the population.

The demographic revolution is determined by two different developments: a sharp increase in life expectancy on the one hand, and the low fertility rate on the other. Both of them induce significant changes in the age structure of the population. Whilst life expectancy at birth has risen from 68 to 78 over the past fifty years, the fertility rate dropped from 2.5 children per woman in the early 1960s to around 1.3 at the beginning of this decade. This is only marginally higher than the record-low fertility rate of 1.2 in Greece, Spain and Italy.

According to OECD projections the result of the combined low fertility rate and increased longevity is a rise in the share of elderly (aged 65 and over) to a quarter of the population by 2030 and consequently of pensioners. Whilst today's ratio of active to retired people is 2.6:1; in 2040, it is forecasted to be 1.4:1.

Even if the fertility rate doubled in the next ten years, it would have next to no impact on the size of the workforce or tax base until the 2030s. And in the meantime, the greater number of children would add to total dependency costs of society.

A popular suggestion to cope with a shrinking workforce is to increase the amount of immigrants. Apart from potential social consequences, a

major problem with this suggestion is the sheer amount of migrants required to fill the gaps. According to UN models Germany would need a net annual immigration of nearly 500,000 until the year 2050 to stabilize the workforce – that is about five times as much as the average net annual immigration since 1996[3]

Further problems arise because of the changing structures of employment. On the one hand, constantly rising levels of unemployment have caused major holes in the funding of the public system, forcing the government to provide an increasing amount of subsidies. The aging of the population and a subsequently expected shortage in skilled labor might deal with this problem to a certain extent. On the other hand, general changing patterns in working life have to be accounted for. Part-time employment is becoming more popular, as are so-called patchwork careers which include leisure time or sabbaticals. Both result in reduced lifetime contributions to the system. The same effect is caused by the increased level of schooling and training a young person receives, leading to a later start to working life than 50 years ago.

To sum up, the German pay-as-you-go-system is not prepared for radical changes in the demographic structure or in work patterns. Although already under strain, the main impact of the change in the age pyramid will only be felt when baby-boomers start to retire, roughly ten years from now. This, according to many observers, provides policy makers with a window of opportunity for a change in the current system that will allow the public, and especially pensioners, enough time to adjust.

The Long Road To Pension Reform

By the end of the 1980s, it became clear that action was needed to restrain the system's rising cost. In the logic of a PAYGO system this can only mean two things: Either pension levels have to be cut or

3 Taking an increased participation rate of women and higher net migration into account, the potential labor force in Germany is still expected to decline after 2010. According to the most realistic scenario, between 2010 and 2040 it is going to decrease from 40.5 to 29.9 million persons or by about 25 percent (Fuchs and Thon 1999).

contribution rates must be increased. According to calculations by the Prognos Institute, the contribution rate was set to exceed 40 percent of gross income by 2035 or pension levels would have to be cut nearly by half if measures weren't taken.

This insight led to a first reform in 1992. The Conservative-Liberal coalition under Helmut Kohl changed the wage base used in indexing pensions from gross to net wages, thus requiring retirees to share some of the burden of rising pension costs. The 1992 reform also raises the mandatory retirement age for all workers to 65 by 2005 and gradually scales back the subsidies for early retirement. Under the terms of the reform, only long-service and disabled workers will be eligible for early retirement by 2012, and then only with reduced benefits. Since the reductions are very gradual, the incentive to retire early will persist.

While a first step, the 1992 reform didn't go far enough. By 1997 the pension contributions had increased to 20.3 percent of the payroll. In the late 1990s a further rise was only avoided by increasing the amount of government subsidies to the system. Political pressure towards reforming the system increased due to the growing amount of taxes and social-security expenses and their perceived stifling effect on German economic growth. By the end of the last decade the overall tax burden in Germany breached 41 percent of GDP – with social security contributions accounting for more than 40 percent of total taxes, by far the highest ratio in the EU[4].

Therefore, in 1997, the Kohl government passed a second reform that would have indexed pension benefits to gains in life-expectancy. The measure, which was not scheduled to take effect until 1999, was suspended by the newly elected Schröder government, as had been promised in the 1998 election campaign[5]. Instead, the above mentioned

4 Contributions to social insurance schemes added up to 18.6 of GDP in 2001 – the highest ratio amongst all OECD countries (Bach *et al.* 2002, p. 662).

5 Even though the influence of pension and health care issues on the election result cannot be judgedd exactly, according to pre-election polls these topics were very important to voters. Moreover, exit-polls show that the SPD gained most among voters of retirement age or approaching retirement, which in turn were the age groups where the decline for the CDU/CSU was largest. (Emmert *et al.* 2001).

"ecological tax" was introduced to finance a cut in payroll contributions, which stood at 19.5 percent in 2003.

Nevertheless the Social Democrat-Greens coalition soon targeted the pension system as a field for a major reform. Penned by the then Federal Minister of Labour, Walter Riester, the pension reform proposal was passed by Parliament in May 2001. In addition to a number of minor amendments[6], the reform contains two major elements.

The first part of the pension reform introduces measures to stabilize the contribution rates to the public pension scheme in the long term when pension finances will come under demographic pressure. The declared ambition of policy makers is to keep the contributions financing public pensions under a level of around 20 percent of the payroll until 2020, and under a level of around 22 percent beyond 2030. This is common ground between the two major parties, the social-democratic SPD and the conservative CDU.

To achieve this goal, future pension expenditure growth was moderated by important changes to the indexation formula that links pensions to the earnings development, thus lowering the current replacement rate from 70 to 64 percent of average wages by 2030. Furthermore, cutbacks have been provided for with regard to occupational disability and permanent disability pensions as well as dependants' pensions.

The difference to the old replacement rate is to be covered through a voluntary and funded pension. This second element of the reform, which has introduced subsidized private pension plans to Germany, is considered a more fundamental change. Starting in 2002, Germans have been able to put up to 4 per cent of their income into subsidized retirement schemes, either individual products dubbed "Riester-Rente" (Riester-pension) or occupational plans offered by employers. Contributions to these savings plans benefit from direct subsidies or tax privileges with a bias in favour of families raising children.

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6 These included the introduction of a need-oriented basic income for pensioners, modification of income rules for survivors' pensions, the introduction of pension splitting for married couples and the introduction of pension funds.

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This new pillar in the pension system will be fully phased in around 2050, but its main implications will be felt from 2011 onwards. If employees save for the Riester-Rente as recommended and these savings were to yield a constant interest rate of 4 per cent, according to government estimates the personal pension accrual would amount to no more than 10.5 per cent of the combined pension benefits for a worker retiring in 2030 (Deutscher Bundestag 2001: 7). Still, the extension towards retirement income policy has effectively converted the German pension system into a multi-pillar approach again after decades of public pension policy and a one-pillar approach[7].

Even though the finance industry quickly pounced on Riester-Rente as a new potential source of income, public acceptance of the products has been sobering. Although roughly 31 million employees are eligible for Riester-products, after two years only about 3.2 million individual contracts were signed – far less than expected (Frankfurter Allgemeine Zeitung, 27.1.04: 21).

There are several explanations for this disappointment. Some experts have criticized the low financial incentives, others that contributing to a Riester-Rente was not made mandatory. In their opinion, to substitute for a significant part of the sinking PAYGO benefits, funded pensions should be universal, and mandatory.

The main drawback of the Riester-Rente, however, seems to be the complexity and over-regulation of the product. Even professionals admit to having a hard time understanding the countless different tariffs and regulations. Another major criticism is that all plans must be capital guaranteed, invariably leading to a lower performance than rival equity-based products. The same applies for restrictions in the use of assets.

The government soon acknowledged that the pension reform of 2001 could not be the end of the road. Likewise, most commentators agreed that the measures introduced were not far-reaching enough to put the

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7 Excluding employers from joint financing is a further major change. This was met by some resistance from the trade unions and the traditional Left mainly because of the high symbolic value, since employers' social security contributions always added to total wage costs, and increases were considered in subsequent wage bargaining.

German public pension system on a sustainable path, i.e. keeping it affordable to employees and employers. Since more radical ideas like switching to a tax-financed basic pension are taboo among the major parties and thus considered very unlikely options, discussion since 2001 has been focussed on further changes to the indexation formula again reducing the replacement rate, scratching perks, raising the average retirement age and promoting private pension plans.

Consequently, these were the main recommendations of the "Rürup-Kommission" of experts, which presented its final report in late 2003. It deemed these changes necessary, as it projected slightly higher contribution rates than the government, if further steps weren't taken. In March 2004 the government adopted all proposals of the Rürup-Kommission with the only exception that the decision on whether to raise the retirement age to 67 will be postponed until 2008 when the labour market situation might have improved. As this reform package did not need approval by the CDU-dominated second Chamber of Parliament, the changes will come into effect as of January 1 2005[8].

Conclusion

Demographics and rising costs have made a major overhaul of Germany's generous public pension system unavoidable. Still, it took many years before this recognition was turned into policy change. After several minor adjustments, the reform of 2001 meant a paradigm shift in public pension policy towards retirement income policy[9]. Even though the most radical element of the reform, the Riester-Rente, has its drawbacks and still suffers from lack of public acceptance, it is a first step on the path many other industrialized countries have chosen:

8 The contents of the package actually resembled the CDU's own proposals put forward by a commission led by former Federal President Roman Herzog quite closely. Therefore resistance would only have been expected on political grounds.

9 For many commentators the really remarkable thing about the reform was the speed in which such a breach with institutional heritage occurred - especially in a country which is characterized by a traditionally strong emphasis on consensus.

transferring responsibility for old-age income provision from the public sector to the individual.

The question remains whether the 2001 reform measures together with recent re-alignments are sufficient to keep the public pension system affordable to society and at the same provide a reasonable means of existence to those who can not forego present consumption in order to provide for retirement. This dilemma is currently being popularised by the media as a "conflict of generations": on the one hand steadily rising numbers of elderly people with enough electoral clout to limit the reductions in the replacement rate and on the other hand a disillusioned younger generation that does not believe it will ever be able to rely on the public pension system and is consequently becoming increasingly unwilling to shoulder the burden of rising costs. The challenge lies in satisfying both groups.

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