Country Report

GERMANY

Current pension system: first assessment of reform outcomes and output

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The Institutional Architecture

Since the Second World War the German pension system espoused the principles of equivalence (a relatively strict link between contributions and benefits) and income maintenance based on the male breadwinner model. As poverty rates among the elderly were very low, German retirement policy was a success. Fiscal sustainability was not a big concern and contribution rates were periodically increased to match expenditures.

From the late 1980s on, however, and especially after the German reunification, the pension debate shifted onto fiscal aspects of the system and mainly revolved around: i) reductions in the financial burden for the state; ii) maintenance of a stable future contribution rate, i.e. reduction in employers' non-wage labour costs.

Since then, a number of reforms weakened the redistributive elements of German pensions and abandoned the income maintenance principle for stable contribution rates, thereby, paradoxically, bringing pension policy further out of line with an increasingly flexible and precarious labour market. In particular, periods spent outside the labour market (child and elderly care, unemployment, military service, higher education, disability and sickness) are treated very unequally.

Beginning in the early 2000s, various scarcely successful attempts have been made to supplement the shortfalls in public benefits with increased occupational plans and individual savings (2001 Riester and 2004 Rürup reforms). This worked only in unionised sectors under collective agreements. Hence, Germany shifted from a (occupationally fragmented) system that protects individuals from social exclusion to a (sectorally fragmented) system whose outcomes are subject to randomness and which may breed poverty during old age.

Germany has recently changed its law regarding **social assistance**. For people with low earnings, including pensioners, there are means-tested benefits to guarantee a basic income. In 2006, this amounted to EUR 8,172 per year in the western Länder, including average benefits for housing and fuel costs. This was equivalent to 19.3% of average earnings.

The **first (state and mandatory) pillar** is divided into: i) compulsory statutory pension insurance for blue- and white-collar employees (*Arbeiter- und Angestelltenversicherung*); ii) pension scheme for farmers (*Altershilfe för Landwirte*); iii) insurance for civil servants and judges – tax-financed (*Beamtenversorgung*); and iv) several professional schemes.

The Statutory Pension Insurance (*Gesetzliche Rentenversicherung*, GRV) covers all German employees (around 82% of total employment), but only certain categories of self-employed: liberal professions who are members of occupational chambers are covered through occupational provision institutes – funded and contribution-financed (*berufsständige Versorgungswerke*); artists, artisans, publicists are all mandatorily covered. Other categories of self-employed either join the GRV voluntarily.

Public pensions are a contribution-financed, PAYG defined-benefit scheme, which has a contingency reserve (*Nachhaltigkeitsrücklage*) of between a minimum of 0.2 and a maximum of 1.7 of monthly expenditure.

The benefit calculation formula is a canonical point system, which brings the defined-benefit nature of German public pensions very close to a defined contributions system. Pension = APV*PP*PF. APV = Actual Pension Value (its amount differs in the western and eastern Länder), PP = Personal Points, PF = Pension Factor.[1] A Personal Point indicates the

[1] I use standard acronyms, often employed by the World Bank. However, each country tends to call its formula components in different ways.

proportion of an individual's wage relative to the national average wage, and the average takes into account the whole working life.
The Actual Pension Value is valorized/indexed to gross wages, but it also depends on two factors: i) changes of the contribution rates to the statutory pension scheme and to subsidized voluntary occupational and personal pension schemes are taken into account (an increase of contribution rates will reduce the adjustment); ii) sustainability factor, which links the adjustments to changes in the system dependency ratio. Both mean that the whole real contributory base is taken into account when valorizing/indexing point values.
These factors limiting valorization/indexation are meant to keep the contribution rate under check. In 2001, in fact, the increase in the rate was limited to 20% by 2020 and to 22% by 2030.
In 2008/2009 total contributions amount to 19.90% and are equally split between the employer and the employee. The insured person contributes 9.95% of monthly earnings; nothing if earnings are less than EUR 400 a month (mini-jobs, voluntary contributions can be made); a reduced contribution, if monthly earnings are EUR 401-800 (midi-jobs). There is an annual ceiling of EUR 63,600 (in the eastern Länder, EUR 54,000). The insured self-employed also contribute 19.9% of monthly income. The minimum monthly contribution is EUR 79.60 and the maximum is EUR 1,054.70 (EUR 895.50 in the east) or a flat-rate amount of EUR 494.52 (EUR 417.90 in the east). The employer normally pays 9.95% of the monthly payroll and 15% of earnings for mini-jobs under EUR 400. The government finances benefits not related to insurance through 1% of VAT and an eco-tax.
The minimum qualifying period is 5 years. The statutory retirement age will increase stepwise (1 month per year until 2024 and 2 months per year afterwards) between 2012 and 2029 from 65 to 67 for both men and women. Flexible retirement is possible between 63 and 65 (67 from 2029) with 35 years of qualifying period. However, early exit implies permanent benefit decrements amounting to 0.3% per month missing to the statutory retirement age, up to 14.4% maximum. (The problem is that low-skilled and low-income workers are usually forced to exit early and are thus more likely to endure these permanent reductions.) From 2012, an exception will be seniority pensions after 45 years of qualifying period (employment, self-employment, care and childrearing up to age 10 count, but not unemployment periods) and age 65. Deferring the pension after 65 (67) earns a 0.5% increment for each month of additional work. Drawing a standard old age pension and receiving extra income is unrestricted.
The main problem with the system is the differential treatment of periods outside work and atypical work contracts.
Women are fairly well protected (during childrearing, care and in case of divorce – as they split entitlements with the former spouse), as are disabled people. Unemployment, especially long-term, is not. Credits for apprenticeships and higher education have been drastically reduced. Atypical jobs are particularly discriminated: part-time jobs called mini- and midi-jobs are partly voluntarily insured and take up is minimal, false self-employment is on the rise and many simply do not save.
The state pays pension contributions for three years per child to either the employed or non-employed parent (or shared). These years are credited with one pension point per child. There are credits for childrearing up to age 10. These years count toward the number of years needed to qualify for a pension (*Berücksichtigungszeit*). If people work and contribute when their children are under 10, they receive a bonus of up to 0.33 pension points per year (up to 1 point per year total).
As for the unemployed, their pension coverage has deteriorated after the Hartz IV law. Normal unemployment insurance gave entitlements before 2006 to 32 months, now (*Arbeitslosengeld I*, ALG I) not more than 12 (24 if older than 55). When this period is over

(too early for many commentators), an unemployed person becomes a recipient of ALG II. Hartz IV transformed the earnings-related means-tested unemployment assistance scheme into flat-rate means-tested basic security scheme for the unemployed (ALG II). This, since July 2009, gives a EUR 359 basis for contributions (producing an entitlement of less than EUR 5 per month of benefits). Finally, unemployment insurance does not contribute to private savings.
Now only first three years of apprenticeship are valued at 75% of average earnings (before more and irrespective of type of job). Credits for educational years after age 16 have been cut from 12 years (before 1992) to zero (after 2009).
Due to increased female employment, part-time work represents now one third of all employment contracts. Only at very high wages it is suitable for old age. The worst development in part-time is marginal jobs (mini- and midi-jobs). In December 2007, there were 4.9 million people having a mini-job and hence earning up to EUR 400 per month. Less than 3% opted in and paid the difference between employer contributions (15%) and full rate of 19.9%. As for midi-jobs, contributions are reduced for employees, but only 12% paid in the full rate.
The **second (voluntary and privately managed) pillar** consists of occupational funded schemes offered by a variety of sponsors and subsidized through tax rebates. German employers have to offer at least one type of occupational pensions (*Entgeltumwandlung*) and have five different options: they can administer the scheme by themselves (*Direktzusage*), through insurance institutions (*Unterstütyungskasse, Pensionskasse* or *Pensionsfond*), they may take out a direct insurance with an insurance company for their employee (*Direktversicherung*). The Federal Institute for Financial Services (*Bundesanstalt fur Finanzdienstleistungsaufsicht*, BAFin) monitors.
Although Germany is said to be a private pensions 'newcomer', life insurance was widespread. Supplementary pensions were mainly for higher-income male workers in large enterprises and used for two purposes: as a human resource management tool to attract high-skilled workers; as a cheap financing method through the tax-free book reserve method. Lower-income employees had occupational schemes in the public sector (mandatory since 1929) and constructions (the unions pushed for it in 1957).
The slow take up of occupational schemes is attributable to relatively tough regulation. Before 2001 only defined benefit schemes were allowed, and employers had stringent information, administration and tax requirements. Indexation was mandatory, as was (almost) reinsurance against insolvency. Eligibility rules (10 years of contributions and a qualifying period of 35) disadvantaged women.
The 2001 Riester reform changed most of the rules. It gave the right to employees to require employers putting a share of gross earnings (tax- and contribution-free) into occupational schemes. However, due to revenue losses this is phased out in 2009. It allowed defined contribution schemes with at least 0% rate of return. Vesting periods were shortened to help women: 5 years of participation and 30 of qualifying period.
However, the main problem with occupational pensions remains the same: that they expanded only in those sectors where collective agreements are being hammered out with the help of trade unions (and often contributions are not even additional as other fringe benefits are diminished). Hence, socially inclusive retirement has now become much more fragmented than it used to be under pure state provision and depends on sector and firm size.
Favourable arrangements exist in public employment, constructions, food and textiles. In metal, chemistry, hostelry, the unions and employer associations have introduced collective sectoral investment institutions (*Versorgungswerke*) but these have had low impact.
Occupational pensions coverage increased by 10% between December 2001 and June 2004, but it is still limited. In 2004, 60% of employees were covered (one third in the public sector,

46% in the private sector). The size of the firm matters a lot: 21% of employees in very small firms were covered; 39% in firms employing 50-99 workers; 86% in firms with over 1,000 employees. The employer and the employee finance most plans jointly. The trend is away from book reserves to out-of-company plans.

Finally, the **third pillar** consists of voluntary, subsidized individual plans, which were strongly encouraged through the 2001 Riester and 2004 Rürup reforms.

The so-called *Riester-Rente* serves the purpose to encourage low-income workers to additionally save. The government recommends 4% of gross wages invested into these plans (and provides tax subsidies or direct allowances on contributions). There are several conditions, which make Riester less attractive (it was simplified in 2005): guaranteed rate of returns, low charges, consumer information requirements. The accumulated assets do not count towards means-testing.

Everyone covered by public pensions can claim state support from Riester (unemployed receiving ALG I are covered but not the self-employed). Full-time carers and child credits are eligible, so Riester undermines the male breadwinner model. To redistribute to women, unisex benefits were introduced.

For the self-employed there are Rürup plans (tax free to a ceiling and protected against insolvency of the self-employed), but again they are less flexible than insurance arrangements.

Hence, for neither plan was take up spectacular. In 2006 there were only 5.6 million *Riester-Renten* covering 15% of eligible people, of whom many were high-income employees. Still some 15% of self-employed (and verisimilarly solo or false self-employed) do not have any kind of old age provision at all.

The Administrative Structure

The Federal Ministry for Labour and Social Policy (*Bundesministerium für Arbeit und Soziales*, BMAS) is responsible for legislation. The Federal Insurance Institute (*Bundesversicherungsamt*) supervises the administrative functions of the Federal German Pension Insurance, which is responsible for day-to-day operations and management.

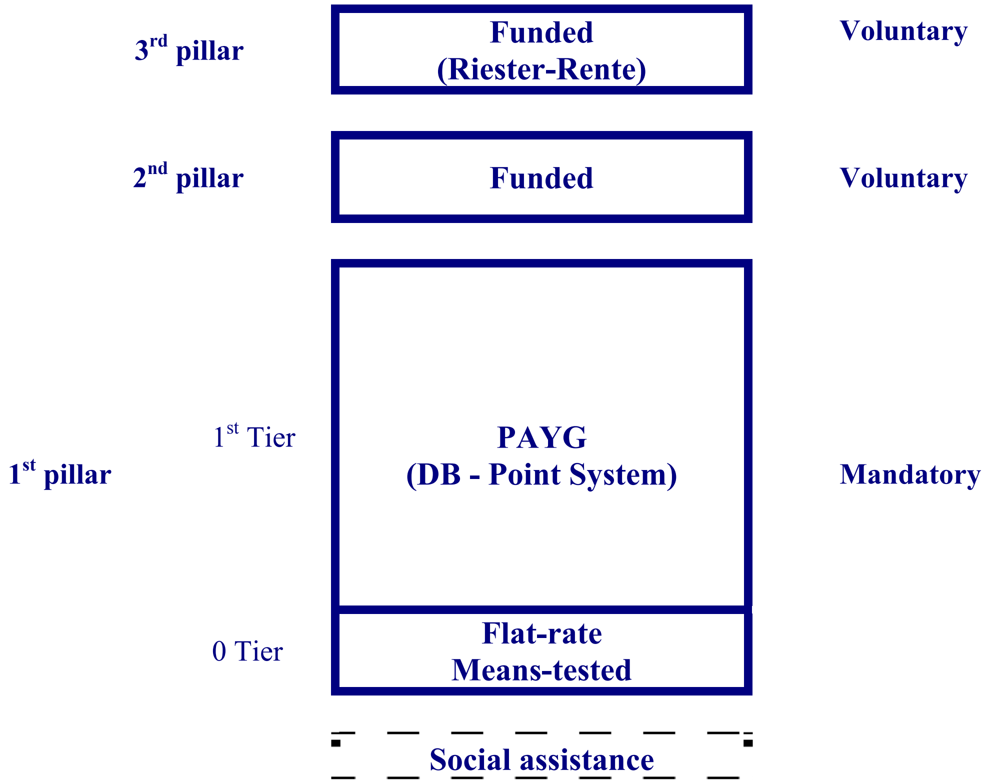
Until 2005, the Statutory Pension Insurance (*Gesetzliche Rentenversicherung*, GRV) had three institutional branches: i) 23 regional insurance funds (*Landesversicherungsanstalten*, LVAs), the federal railway insurance fund (*Bundesbahnversicherungsanstalt*) and the seamen insurance fund (Seekasse) administered all blue-collar workers and insured self-employed; ii) the Federal Insurance Fund for Salaried Employees (*Bundesversicherungsanstalt fur Angestellte*, BfA) administered white-collar workers; and iii) the Federal Insurance Fund for Miners (*Knappscheftliche Rentenversicherung*). These pensions insurance carriers were united into the Federation of German Pension Insurance Institutes (*Verband Deutscher Rentenversicherungstrager*, VDR). Its board was equally split between employers and employees. In 2005 VDR and BfA merged into the DRB and the number of LVAs will be reduced due to regional mergers.

The Federal Institute for Financial Services (*Bundesanstalt fur Finanzdienstleistungsaufsicht*, BAFin) monitors private pension funds and plans under the supervision of the Ministry of Finance.

Assessment and Future Challenges

Even though the German public pillar is still a guarantee against poverty in old age, the equivalence principle on which it is based and the cuts in its redistributive elements imply that it is sliding out of line with an ever more flexible labour market. Hence, as written in the introduction, Germany shifted from an occupationally fragmented system that largely protects individuals from social exclusion to a sectorally fragmented system whose outcomes are subject to randomness and which may breed poverty during old age. According to experts it has now the option to follow two different developmental paths: either continue with a voluntaristic approach, as in the United Kingdom and relegate its elderly poor to social assistance, or espouse the universalism of a Dutch or Danish public scheme and mandate additional private savings to low-income workers and atypical job holders.

Figure 1 The Main Pillars in the German Pension System



1st Pillar, universal coverage (certain categories of self-employed are excluded);
2nd Pillar, occupational schemes;
3rd Pillar, individual programmes.

Annex 1

Key Data about the Pension System in Germany

Contribution rates – 1st pillar		
Dependent employment	Self-employment	Atypical (mini-jobs)
9.95% employees	19.9%	4.9% employee (voluntary)
9.95% employers		15% employer

Supplementary schemes	
Contribution rates	Dependent on individual scheme
Coverage (of employees)	60%
Assets in EUR bln (2007)	428.7
Taxation	Exempt Exempt Taxed or Taxed Exempt Exempt
Investment principles	Quantitative Restrictions/Prudent Person Principle

Theoretical replacement rates	Gross			Net
	1st pillar	2nd pillar	Total	Total
2005	43%	0%	43%	63%
2050	34%	15%	48%	67%

SILC income 2004	Total	Male	Female
Relative income of 65+	0.92	0.93	0.90
Aggregate rep. ratio	0.45	0.44	0.48

Eligibility retirement age	
Old age	65 (rising to 67 by 2029, 1 month per year until 2024 and 2 months per year afterwards)
Seniority	45 years and 65 years of age after 2012
Early retirement	Flexible between 63-67 with maluses
Deferred retirement	Unlimited (6% bonus each year)

Indexation	Gross wages with self-equilibrating factors

Public pension spending (as % of GDP)	2004	2020	2050
	11.4	11.0	13.1

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