# The distribution of wealth and the reform of the compulsory pension system in the Federal Republic of Germany

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## Contents

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## 1. Introduction

The structure of the compulsory pension system (CPS) in the Federal Republic of Germany has been changed fundamentally. The federal government has decided to introduce a private pension system on a voluntary basis. The payments to this voluntary system are to constitute a capital stock to supplement the payments of the compulsory pension system. Comprehensive fiscal subsidies will be introduced to support this change to the pension system.

This paper discusses the special situation of families with children. The second section investigates the extent to which families with children were able to accumulate private wealth in the last ten years in Germany.

In the third section the main features of the intended changes to the compulsory pension system are described, and an overview of the planned fiscal subsidies is provided.[2]

In the fourth and final section we attempt to evaluate the changes with particular attention to the situation of families.

## 2. The Relative Wealth and Distribution of Wealth among Families

The wealth of private households in the Federal Republic of Germany (old and new Länder) has increased greatly in recent years. For the year 1990 the *Deutsche Bundesbank* (German Federal Bank) calculated the net total wealth of private households to be 8.2 billion DM. For

[1] This paper is a partial result of a research project on the distribution of wealth in the Federal Republic of Germany and was represented at the „Eighth International Research Seminar on Issues in Social Security“ of the „Foundation for International Studies on Social Security“ in Sigtuna/Sweden. The research project was financed by the Citibank Foundation (formerly the Stiftung der Private Haushalt). Details about the pension reform were taken from the home pages of the Federal Ministry for Labor and Social Order (*Bundesministerium für Arbeit und Sozialordnung*: www.bma.bund.de) and the Association of Public Pension Funds in Germany (*Verband der Rentenversicherungsträger in Deu*tschland: www.vdr.de). The Internet pages of the ministry also describes the structure of the reform in English. Here we would like to thank Claus Becher for the research he performed.

[2] Note that for this analysis the support measures of the compulsory pension system directed toward families constitute only one element of the state's financial support for families. On the basis of the Basic Law (*Grundgesetz*: GG) of the Federal Republic of Germany, according to which the Federal Republic of Germany constitutes a democratic and social federal state (Article 20(1) GG) in which marriage and the family are subject to special protection by the order of the state (Article 6 (1) GG), a variety of further measures exist for the support of families. Since these measures, however, do not refer directly to the connection between the support of families and the payments of the compulsory pension system, they will be listed here only for the sake of completeness. Of particular importance are child benefits, benefits for maternity or paternity leave, tax subsidies, increased benefit rates for unemployment insurance and additional state measures such as the subsidization of kindergartens and the public school system.

the year 1997 this value increased to 12.1 billion DM (*Deutsche Bundesbank* 1999, 43). The used wealth term comprises the property assets, the financial assets and the consumer durables. The debts for housing and landed property and the consumer liabilities are subtracted from the sum, which is shown as whole gross wealth. The result is the whole net wealth.

The wealth of private households can be analyzed on the basis of micro-economic surveys. At present the Income and Consumption Surveys (*Einkommens- und Verbrauchsstichproben*: EVS) of the Federal Statistical Office (*Statistisches Bundesamt*) are the only micro-economic data available. The EVS has been performed regularly, approximately every five years, since 1962. The survey also collects information about the wealth and debts of private households. The results presented here are based on the surveys from the years 1988, 1993 and 1998.[3]

The concept of wealth is defined relatively strictly in the EVS. The total gross wealth of a household comprises only the sum of the gross monetary wealth and the gross property wealth. Debts in the form of mortgages and consumer credits are deducted from this total. This resulting value of net total wealth per household is used for analyses. The concept of wealth used here incorporates the productive wealth of private households to a relatively minor degree, as it is taken into consideration only when it exists in the form of quoted shares. The study does not take consumer durables into account at all.

In analyzing the results it is also important to note that the EVS does not represent all groups of households in the Federal Republic of Germany. For instance, households with a monthly net household income of over 35,000 DM are not included, as too few households at this level of income took part in the survey. Neither individuals without a permanent residence nor the institutionalized population are included in the survey. The inequality of the distribution of wealth described here is undervalued as a result. Furthermore it should be mentioned that the households of foreigners were questioned only since the year 1993 and that the results for the year 1988 are valid only for the old Länder.

On the basis of the empirical results below we investigate the wealth of families with children as compared to that of families without children. Of particular interest is whether families with children have been able to amass great amounts of assets in the past. Here the net total wealth of a household is divided by the number of persons living there. This means that the

[3] The results are determined using an 80-percent depersonalized sub-sample from which are grossed up to the entire population. Because the sub-sample of any given year includes approximately 50,000 households, it is possible to break down the samples extensively according to various Socio-Economic criteria. At present there are very few analyses of the distribution of wealth in Germany which are based on micro-economic data over a long period of time. Particularly worthy of mention are the *Ergebnisse der Bundesregierung* (Results of the Federal Government) 2001, 44-74, of the *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung* (German Council of Economics Advisors) 2000, 261-269, by Schüssler et al. 2000 and by Hauser and Stein 2001.

results presented here were calculated on the basis of per-capita assets.[4] The outcomes are in generally valid for persons, who live in households discriminated by the respective household typ. For cause of simplicity we will speak only of households in the following.

Table 1 shows the average net wealth of private households in western Germany on the personal level for the years 1988, 1993 and 1998, divided by type of household. Since reunification of the Federal Republic of Germany did not occur until 1990, the corresponding values for eastern Germany are included only for 1993 and 1998. The percentile values also included are based on the average for the total sample of a given survey year, whereby separate averages are calculated for western and eastern Germany. The analysis does not differentiate between households comprised of unmarried couples and married couples: decisive for the classification as a particular type of household is the existence of a shared household. The “other households” are a residual group comprising shared residences and families in which other relatives reside.

First, let us examine western Germany. From Table 1 it is evident that the relative wealth of all types of households with children fell in comparison to the total average over the period from 1988 to 1998. In 1998, couples with one child attained a value of only 85%, and those with two or more children only 66% of the average for all households. At just 46%, the relative wealth of single parents in 1998 is far below the average. This development is particularly evident for the second period of investigation from 1993 to 1998, as here even the absolute values sank for the household types with children, and especially for single-parent households.

In contrast, couples without children occupy an extremely superior position of relative wealth, with a value of 142%. For this group of households the possibility that both partners are gainfully employed makes it possible to amass an above-average amount of wealth. A great improvement in the relative wealth of single men is also evident, for this group was able to double its average wealth from 76,000 DM to 151,000 DM in the period from 1988 to 1998, while the average for all households during this period increased from 73,000 DM to 118,000 DM, or only around 60%.

In eastern Germany, reunification made for a special situation. In general we observe significantly lower assets than in western Germany. However, the clear trend is that eastern Germany is catching up, as evident in the rise in the average total wealth of all households from 32,000 DM in 1993 to 45,000 DM in 1998, an increase of over 40%. While the average

[4] Here we assume the equal distribution of wealth within a given household, an assumption which certainly deserves critical scrutiny. However, in comparing the relative wealth of various households this per capita wealth appears more sensible than the wealth of an entire household, as the latter would entail the direct comparison of the values of one-person households with those comprising four or more members.

value in eastern Germany in 1993 was only 30% of the western German value, the figure of comparison reached 38% just five years later.

**Table 1:** Net wealth of private households in western and eastern Germany on the individual level in the years 1988 through 1998, by type of household (amounts given in DM and percentages calculated from the respective average)

| Type of household | West | | | East | |
|---|---|---|---|---|---|
| | 1988 | 1993 | 1998 | 1993 | 1998 |
| Single women | 75,000<br>102% | 123,000<br>112% | 127,000<br>108% | 29,000<br>92% | 35,000<br>79% |
| Single men | 76,000<br>105% | 124,000<br>113% | 151,000<br>128% | 36,000<br>111% | 42,000<br>93% |
| Couples without children | 100,000<br>137% | 154,000<br>140% | 167,000<br>142% | 40,000<br>124% | 59,000<br>131% |
| Couples with 1 child | 73,000<br>101% | 103,000<br>94% | 101,000<br>85% | 33,000<br>102% | 45,000<br>101% |
| Couples with 2 or more children | 58,000<br>79% | 80,000<br>72% | 78,000<br>66% | 29,000<br>90% | 39,000<br>87% |
| Single parents | 44,000<br>60% | 67,000<br>61% | 54,000<br>46% | 13,000<br>41% | 18,000<br>40% |
| Other households | 67,000<br>91% | 113,000<br>103% | 138,000<br>117% | 39,000<br>121% | 56,000<br>125% |
| Total | 73,000<br>100% | 110,000<br>100% | 118,000<br>100% | 32,000<br>100% | 45,000<br>100% |

*Notes:* Amounts rounded up to the next 1,000 DM. Every average value is calculated per capita for the respective type of household.
*Source*: EVS Database of the Chair of Social Policy of the Goethe University of Frankfurt a.M.; own calculations.

The relative wealth of couples with children in the new federal states can be viewed somewhat more favorably than that of the same groups in the old federal states, for the eastern couples with children were able to maintain their relative wealth positions and even achieve significant improvement in terms of absolute wealth. Especially inferior is the relative wealth of single parents, however, as these exhibit only a minimum level of wealth in 1998, with an average of 18,000 DM, or only 40% of the average value for all eastern German households.

As in western Germany, in the five new federal states the situation of couples without children is relatively good: they achieved a level of 131% of the average of all eastern German households.

In summary, from Table 1 can be concluded that the average family with children in western Germany was not able to amass any wealth over the last five years observed. Moreover, the particularly unfavourable wealth situation of single parents in both parts of the country is striking. In contrast, couples without children achieve the highest average levels of wealth in both eastern and western Germany.

The average values mentioned here do not offer any information about the distribution of income within individual socioeconomic groups. For this reason a more in-depth analysis of distribution was performed by dividing each household group into sub-groups according to relative wealth. Here, too, the values are based on wealth per capita. Only the last survey year, 1998, is considered below.

From Table 2 it is evident that a total of 5.4 % of the households in western Germany are overindebted. However, it must be noted that consumer durables are not taken into account in the concept of wealth and these debts thus may be balanced by them. 20.9% of households possess only “emergency reserves,” comprising less than 11,800 DM in 1998. On the other hand, 22.2% of households have 1.5 times or more the average net wealth per person. These households thus possess a net wealth of over 177,000 DM per person.

Regarding the individual types of households it is evident that couples with one child and couples with two or more children are represented in the lowest two groups about as frequently as the total average of all households, a rate of around 26%. These groups endowed with below-average wealth include higher proportions of single men (39.3%), and especially single parents (57.1%).

**Table 2:** Distribution of persons in private households by relative magnitude of net wealth in 1998 in western Germany (amounts in % of all persons)

| | Type of household | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net wealth from .. to .. of the average | Single woman | Single man | Couples without children | Couples with 1 child | Couples with 2 or more children | Single parents | Other house-holds | Total |
| Negative Wealth | 4.7 | 10.1 | 3.7 | 6.1 | 5.2 | 11.7 | (3.6) | 5.4 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| 0 up to 0.1 | 31.2 | 29.2 | 14.7 | 20.2 | 19.2 | 45.4 | 13.4 | 20.9 |
| 0.1 up to 0.5 | 25.6 | 21.4 | 20.4 | 21.6 | 25.5 | 19.1 | 15.7 | 22.3 |
| 0.5 up to 1.0 | 8.3 | 9.2 | 10.4 | 18.6 | 27.3 | 9.3 | 21.2 | 17.0 |
| 1.0 up to 1.5 | 5.2 | 4.7 | 12.8 | 15.2 | 13.8 | 5.3 | 18.7 | 12.2 |
| 1.5 and over | 24.9 | 25.5 | 38.0 | 18.4 | 9.0 | 9.2 | 27.3 | 22.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Notes*: The total average per person is 117,979 DM. For values in parentheses the number of cases is less than 60.
*Source*: EVS Database of the Chair of Social Policy of the Goethe University of Frankfurt a.M.; own calculations.

At the other end of the spectrum, the category with the greatest wealth, meaning 1.5 times or more the average wealth of all households, include fewer couples with one child (18.4%) and especially few couples with two or more children (9,0%) as compared to the average of all households (22.2%). This is also proven for single parents: 9.2% are in this category of wealth.

By 1998, in contrast, couples without children were represented in the highest category of wealth with above-average frequency (38.0%).

As a result it can be concluded that Table 2 also shows the below-average possibilities in western Germany for couples with two or more children, and especially for single parents, to amass wealth.

The distributional situation in eastern Germany in 1998 is illustrated in Table 3. In the lower categories of wealth it shows great similarities to the western German case. In this part of Germany 6.3% of households are overindebted and 16.1% of households have only “emergency reserves.” Due to the lower amount of wealth possessed in eastern Germany, these reserves are less than 4,500 DM.[5]

The two lowest categories of wealth include 35.4% of single men and 52.0% of single parents. These groups are thus represented significantly more frequently in the group of households that are overindebted or achieve only a minimum level of wealth than the 22.4% of all households.

**Table 3:** Distribution of persons in private households by relative magnitude of net wealth in 1998 in eastern Germany (amounts in % of all persons)

[5] It should be mentioned that this value is very low. The net income of east German households was 80% of the value for the west German households in the year 1998. If we would transfer this relation to the analysis of wealth the value for the „emergency reserves“ was 80% of the west German value and so 9,500 DM.

| | Type of household | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net wealth from .. to ..of the average | Single woman | Single man | Couples without children | Couples with 1 child | Couples with 2 or more children | Single parents | Other house-olds | Total |
| Negative Wealth | (2.8) | (9.7) | 3.4 | 6.5 | 9.0 | 12.2 | [3.6] | 6.3 |
| 0 up to 0.1 | 26.0 | 25.7 | 10.4 | 13.7 | 13.8 | 39.8 | (9.4) | 16.1 |
| 0.1 up to 0.5 | 34.8 | 28.1 | 28.9 | 29.7 | 27.3 | 28.5 | 28.3 | 29.1 |
| 0.5 up to 1.0 | 17.0 | 13.4 | 19.7 | 15.3 | 18.0 | 7.7 | (14.9) | 16.8 |
| 1.0 up to 1.5 | 7.6 | (5.1) | 10.0 | 11.0 | 11.5 | [4.1] | (13.6) | 10.0 |
| 1.5 and over | 11.8 | 18.0 | 27.5 | 23.9 | 20.3 | 7.8 | 30.1 | 21.6 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Notes*: The total average per person is 44,611 DM. For values in parentheses the number of households in the cells is less than 60; for values in square brackets, under 30.
*Source*: EVS Database of the Chair of Social Policy of the Goethe University of Frankfurt a.M.; own calculations.

Now let us turn to the highest category of wealth. In contrast to western Germany, at 20.3% the relative wealth of couples with 2 or more children in eastern Germany hardly deviates from the value for all households in that region, 21.6%. At 23.9% of households, couples with one child are actually over-represented in this category of wealth. As in western Germany, eastern German single parents achieve such a high level of wealth quite rarely (7.8%). And in contrast to the old federal states, this statement is also true for single women, for whom the corresponding value is only 11.8%.

The analyses of the distribution of wealth in the Federal Republic of Germany have shown that families with children have had greater problems amassing wealth than other groups of households. This is true to a greater degree for families with more children, especially in western Germany.

Furthermore single parents in both parts of the country are endowed with far below the average amount of wealth. Thus the relative wealth of this household group must be described as especially poor.

## 3. Pension Reform with Special Allowances for Families

### 3.1 The Existing System of Old-age Pensions

Through the introduction of a mandatory old-age pension, protection of the older generation was shifted to a societal level.This system is financed on a pay-as-you-go basis.

Through such a system the individual risks of age of the generation gainfully employed, be they childlessness, loss of income due to illness, unemployment, premature inability to work or death of a partner, are borne by society as a whole as a kind of insurance and reduced to an average risk. Such risks could be borne only in part or with great difficulty by an entirely private old-age pension system.

The German CPS is a benefit-defined system. Pension claims are accumulated during the entire working life. Each year the individual wage is compared to average wage. If the individual wage equals average wage the insured person receives one remuneration point. Higher or lower individual wages result in more or less than one remuneration point. At retirement the remuneration points are added up and multiplied by a factor depending on the current average net wages (pension formula).

However, the existing compulsory pension system would face considerable financing problems in the future without a pension reform, for if the present demographic developments continue, the rates of contribution will not suffice to maintain current pension levels. The causes are steadily declining birth rates and a simultaneously rising life expectancy over the last decades, without any significant change in the age at which the working population enters retirement.[6] This development is expected to continue in the future. Accompanied by a strong rise in the percentage of the elderly, the result would be steadily increasing rates of contribution.[7]

### 3.2 Reorganization of the System of Old-age Insurance

The German government reformed fundamentally the system of old-age insurance. The goal of the reform is to initiate broad-based, voluntary funded old-age insurance for employees as a supplement to the existing system. These new ways of capital formation are designed to

[6] An overall view of the age of working people entering retirement is given in „Übersicht über das Sozialrecht" (Ed. Bundesministerium für Arbeit und Sozialordnung 1998, 245). This table is valid for the CPS of workers and employees for the years 1957 to 1996. It shows that the age for entering retirement for women was 58,6 years in the year 1957 and 60,9 years in the year 1996. For men there was almost no difference between this classes with 59,9 years in 1957 and 59,6 years in 1996. The fluctuation of retirement age between the years 1957 and 1996 was around two years.

[7] As of 01-01-2001 the rate of contribution to the compulsory state pension system was 19.1%, whereby 50% of this contribution was borne by the employer and 50% by the employee. Model calculations indicated an expected rise in the rate of contribution to 26% in the year 2030 if no changes were implemented. The net pension level is defined here as the ratio of the gross pension of an average earner with 45 contribution years (basic pensioner) less contribution for health insurance to the average net income of the pension insured persons. Currently this pension level is around 70%.

guarantee an adequate standard of living for the elderly despite a reduction of the public pensions. The reform will result in a future pension level that is oriented toward a rate of contribution legally limited to a maximum of 22%. Thus the increase in the rate of contribution described above will be restricted. However, this will lead to a reduced pension level of currently around 70 % to at least 67% in the future. In addition, the predicted increase in part-time work will lower the average income, further dampening the rates of increase for pensions such that these will fall even further behind the income trend for full-time employees. The capital based additional pension is to compensate for these reductions in pension payments.

The main features of the elements implemented to reorganize the pension system are described below. Special attention is paid to the support measures specific to families; these are then related back to the findings about income distribution discussed in the previous sections.

First of all it must be mentioned that the reform 2001 of the CPS will lead to some structural improvements. This is particularly valid for women who are or were engaged in child care.

A combination of changes to the evaluation of periods of contributing to the CPS through part-time work combined with bringing up children, and changes in the form of the survivors' pension are to take better account of parenting in old-age insurance. Besides the revaluation of child-rearing, pension claims earned through part-time employment by the parents are also increased: a parent working part time now has the right to a pension calculated at the level of an average income -- for each year until the child has reached the age of eleven. If no employment is possible because the parent is bringing up several children, nevertheless remuneration points are awarded for the old-age pension.

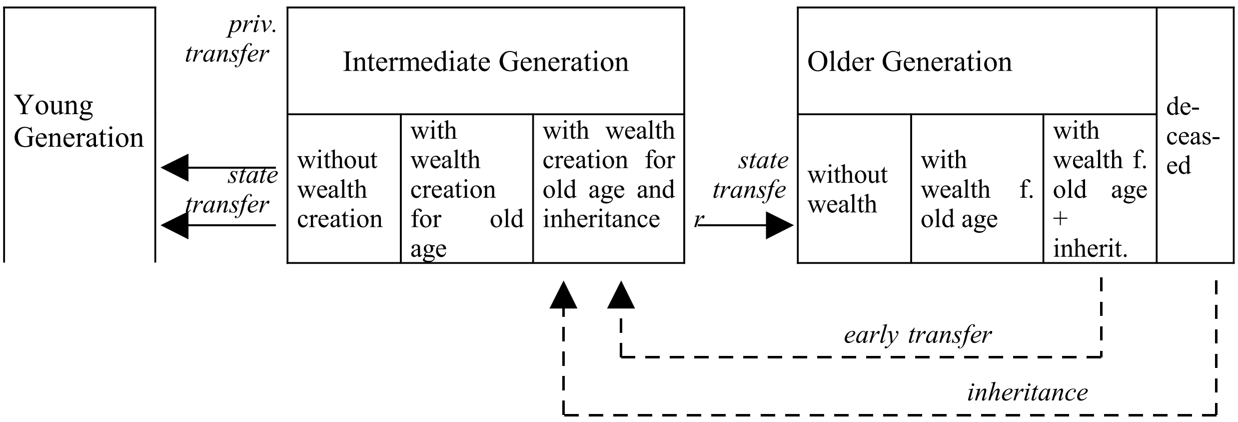
For persons over 65 years of age, a needs-based basic pension is to be introduced which should prevent poverty in old age and in the case of permanent inability to work better than does the existing social welfare system. This basic pension is conceived as special social welfare without resort to children and parents.

Figure 1 offers a simplified overview of the planned structure of future old-age insurance for employees, whereby distinctions are made among different groups of the population according to generation-membership and level of wealth. The following comments are restricted in this analysis to income and thus to the consumption potential. These remarks extend beyond this in considering the desire and potential to donate or bequeath wealth to the succeeding generation. This motive of transmission through inheritance is customary among many elements of the population, for the life-cycle hypothesis that each old-age generation uses up the wealth it saved has been disproved empirically.

The investigation is simplified through the use of a three-generation model of society. In this extremely schematic model, the intermediate generation receives its primary income from work. This income then also supports the young, not yet employable generation. In addition to these private transfers from the intermediate to the younger generation, in Germany state transfers are also provided (child benefits, benefits for maternity or paternity leave, etc.) to support families in their socio-political function of bringing up children.

Similarly, the payments from the CPS for the older generation that has left the workplace are financed by the intermediate generation. Jumping forward one generation, the younger generation becomes the intermediate generation, the intermediate becomes the older generation, and what previously was the older generation is deceased.

**Figure 1:** Three-generation contract with voluntary committed and subsidized wealth creation for old age on the individual level




*Source:* own illustration

The pension reform currently underway supplements this system with a voluntary model of self-provision committed to this purpose and subsidized by the state. A prerequisite for this is high capital formation by the working population and the opportunity to invest capital. During the phase of gainful employment, capital is saved and private wealth accumulated. This wealth, together with the returns on this wealth, are to contribute to financing consumption and thus the standard of living in old age. The system of capital funding is thus added to the existing apportionment system. To prevent the accumulated wealth from being consumed in part or in full due to a contingency occurring during the phase of gainful employment, the wealth saved is committed to the pension so that using it up is prohibited before retirement age has been reached. In order to make the voluntary savings model attractive to large sectors of the population, this renunciation of consumption during the phase of gainful employment is subsidized by the state.

The formula for adjusting pensions also has been changed so that pension adjustment is dependent on the rise in average gross wages, on the change in the rate of compulsory contribution to the CPS and on the imputed rate of savings for voluntary old-age insurance. This new adjustment formula results in a step-by-step reduction of the pension level and a lower rise of each individual pension than the system today provides for.

Under the new system, the compulsory rate of contribution for the employer is to rise to no more than 11% by the year 2030. For the employee, on the other hand, the sum of the compulsory rate of contribution and the imputed rate of savings is to climb to 15%. With this the existing equal financing of old-age insurance by employer and employee has been abandoned, at least in part. However, old-age insurance provided by companies is to be improved and linked to the new instrument of private old-age insurance. Through this the employer may be integrated more strongly into the new system.

The intermediate gainfully employed generation is composed of three subgroups:[8]

The first group comprises households without wealth creation. In old age, this group lives only from the payments of the CPS. The form of voluntary savings for old age presumably will have the consequence that only part of the population will make sufficient provisions for old age. In some cases the reason may be that future needs are underestimated; in others, the present income may not be high enough to allow for the necessary savings. An additional problem involves the occurrence of non-insured contingencies among youths or individuals in the workforce. These problems can lead to poverty if the payments from the apportionment system are reduced to a considerable degree.

Based on the results represented in Tables 2 and 3 in section 2, the group that does not make voluntary provisions for old age would likely include at least those households which are either overindebted or have at their disposal less than one tenth of the average level of wealth.

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[8] For the sake of simplification the fluctuation between subgroups is not considered in this description.

These households of the lowest two wealth categories comprise around 25% of all households in eastern and western Germany.[9]

The second group comprises households with voluntary wealth creation for the purpose of consumption in old age. These households will exhaust the supply of wealth saved for old age by the time they die, leaving no substantial inheritance. The size of this group is quite difficult to estimate, as it depends on many factors which are difficult to determine.

Thirdly, there is a group of households with wealth creation for the purpose of consumption in old age that also saves capital to bequeath to the next generation. This group itself may receive additional inheritances.[10] These households include at least those households with over 1.5 times the average wealth at their disposal. This group thus should include at least 20% of the population, as shown in Tables 2 and 3 in section 2.

Accordingly, the older generation consists of three subgroups:

The first subgroup comprises those persons who have not accumulated any wealth. These persons live only from the payments of the apportionment system and from state transfers.

The second subgroup accumulated wealth during the phase of gainful employment, but uses up practically all of this wealth by the time it dies.

And the third subgroup accumulated wealth through its own savings and may have been able to increase this wealth further through inheritances received. These individuals can support their costs of living both from state transfers and from returns on their wealth and the liquidation of their wealth. Because this group generally can use part of its total income to increase its savings, the inheritance available upon its death increases.

### 3.3 Description of the Planned Support

Planned is the introduction of a voluntary, supplementary provision for old-age. This provision is individualized and accompanied by a tax-free allowance for contributions to saving up to a level of four percent of the monthly wage. The tax subsidy may not exceed the limit for calculating contributions to the CPS.[11] A state subsidy may be claimed as an

[9] The argument against this view would be that especially younger households are not yet in a position to accumulate larger assets so that a larger amount of wealth is present by the end of the phase of gainful employment. While it is correct that the average level of wealth of a household increases with the age of the head of the household, control calculations for the year 1998 showed that the proportion of households in the two lowest wealth categories which are headed by an elderly member is only slightly lower than the value for all households.

[10] The households in this sub-group are certainly not the only ones that may inherit. For the sake of simplification in the context of this study, however, it is assumed that (more extensive) inheritances are linked to the opportunity to create additional capital supplementary to voluntary old-age insurance.

[11] The CPS reform 2001 is relevant only for employees insured by the compulsory pension system. However, the intention is to apply this reform to other sub-systems of old-age insurance as well, at least in its general approach. These sub-systems include support for civil servants, agricultural pensions and perhaps professional pension systems as well. Those changes to old-age insurance provided by companies also implemented in the reform are

alternative to the tax subsidy. This payment is dependent on the number of children and decreases as a percent of income when income rises.[12] It consists of a basic allowance per year of up to 300 DM per adult and a child allowance of 360 DM per child.[13] Hence state support for contributions to savings favors families with children. Initially it is reduced as income rises, but the opportunity for a tax subsidy effects a U-shaped percentile rate of subsidization. This effect is illustrated graphically in Figure 2 for various types of households and income levels. The highest percentile savings subsidy will be received by those households which earn very little income and by those which earn most. This tempts speculation that on the one hand households with low income can not use the high percentage support because of their low ability to save. On the other hand households that earn high incomes will be able to use the subsidy by shifting elements of wealth or previous savings, without having to increase savings at all. This subsidy generates a strong incentive to take advantage of free ride effects.

**Figure 2:** Rate of State Benefits for Savings Contributions to Private Pension Plans as a Function of Household Income subject to CPS, in %

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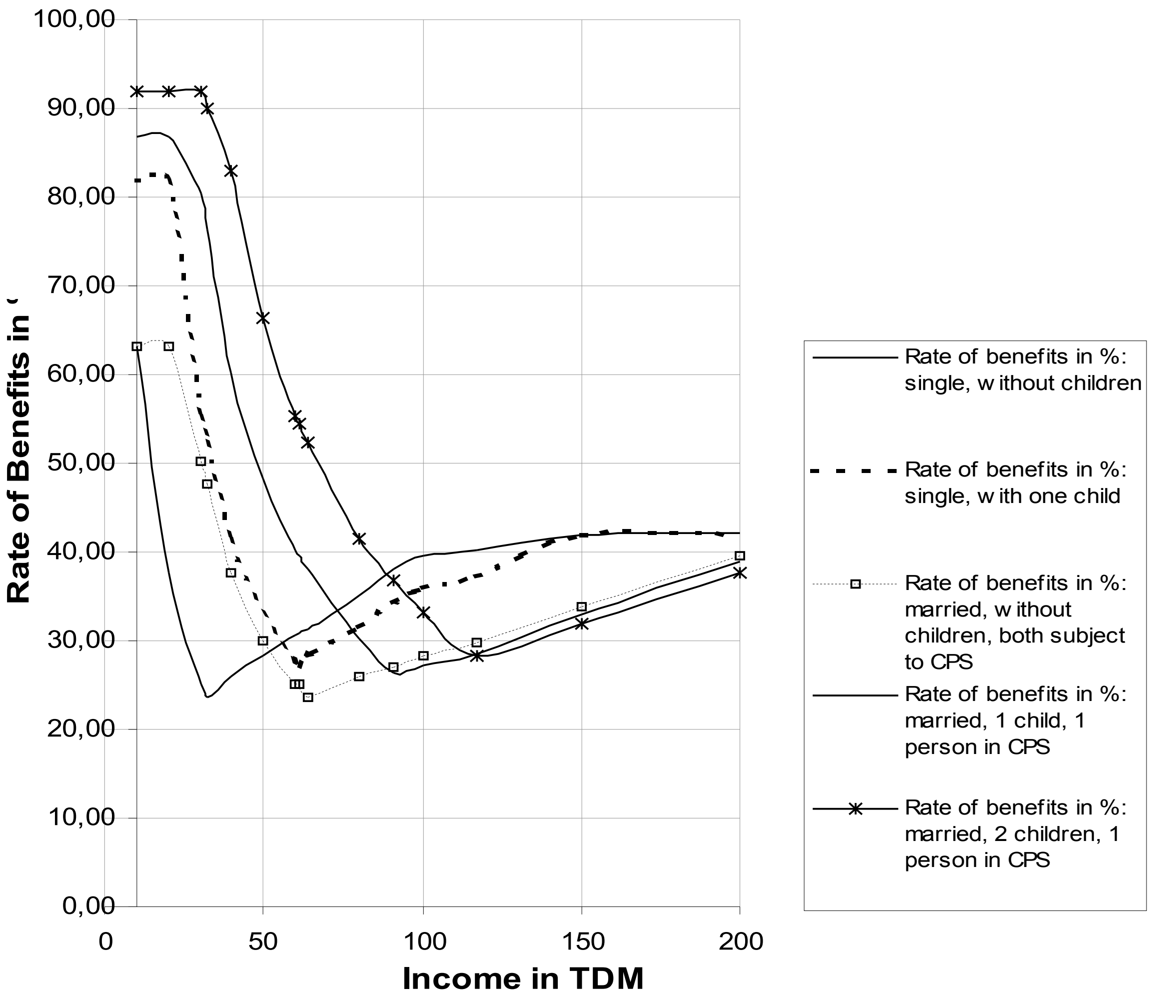
also to be applied to the supplementary support in the civil service.

[12] A check of beneficialness yields the following income values for which a tax-free allowance is more advantageous than the direct state subsidy (values refer to gross annual income): singles without children 30,600 DM; single parents with 1 child 47,000 DM; single parents with 2 children 60,000 DM; married without children 62,000 DM; married with 1 child 78,000 DM; married with 2 children 93,800 DM, and married with 3 children 107,000 DM.

[13] The values given here refer to the final stage of the reform in the year 2008. Before that the rates of support will be introduced step by step in 2002, 2004 and 2006. In the final stage, subsidization by the state will amount to 20 billion DM per year.




*Remarks:* The curves were generated through interpolation. The income paid for compulsory pensions corresponds to the household income in DM subject to compulsory pension system (CPS) payments in the previous year.
*Source:* Own illustration on the basis of data from the Federal Ministry for Labor and Social Order.

The capital can be invested only in state-certified forms of investment which guarantee that the funds are committed to old-age insurance. Only the nominally deposited capital must be guaranteed when the age of retirement is reached. There is no legally prescribed payment of interest as for capital-based life insurance.

## 4. Assessment and Summary

Due to the planned institutional changes, only limited prognoses are possible about the financial security of the older generation of the future. However, on the basis of the planned changes, several tendencies can be expected:

- The lack of wealth owned by the lower 25% of households makes it appear improbable that all households will perform substantial voluntary wealth creation to supplement the state's old-age insurance. State support presumably will lead to additional savings primarily in households that already were able to accumulate a moderate capital stock. In contrast, the wealthiest group already can use the wealth it owns to maintain its standard of living. There is the danger of free riders emerging if this group of households partially replaces its existing investments through the new forms of investment to be created and subsidized by the state.

- Also worthy of criticism is the law's stipulation that only the nominal value of investments be guaranteed, as the real value of these deposits may be significantly lower once a phase of gainful employment lasting twenty or thirty years comes to a close. Introducing a minimum interest payment would have reduced this risk to some degree. Also missing is any guarantee of complete protection against inflation or a supplementary pension that rises with the real rate of wage growth.
- Different levels of success achieved by the providers of various financial products may result in a wide gap between the values of different supplementary pensions. Depositors also face the danger of insufficient consultation and advertising by the suppliers of investment opportunities. Temporal variations in the value of capital and interest rates also may mean that some enter retirement during an unfavorable situation for capital markets. All of these effects increase the risk for the older generation of the future.
- Since the supplemental provision was not set up as compulsory insurance for all individuals covered by the CPS, many elements of this system of social compensation no longer can be executed directly. In particular, it can not compensate for the different life expectancies of men and women, as the free selection among certified investment products prevents the introduction of a unisex life-expectancy table. Thus women either must save more for a certain supplementary pension than men, or receive a lower supplementary pension for equal contributions to savings.
- If events like illness, unemployment and premature disability occur, causing a loss of income during the phase of gainful employment, it appears questionable that an individual can continue during this period to set aside the savings intended for a supplementary private pension. However, the suspension of a contract or a reduction in payments results in a lower supplementary pension. Thus the risk of an even wider range of values of supplementary pensions arises, as the risks mentioned above often are more likely to occur in the lower wage groups.
- The improvements to the CPS for women in the form of increased claims for child-rearing are cancelled out by the reductions by the level of the compulsory pension.

- The wealth created in the context of the savings committed to old-age provision will be wealth earmarked for consumption in old age. Since it cannot be bequeathed directly, the widespread desire to leave an inheritance cannot be realized.
- There is the risk that the subsidization of savings for old age will be reduced in a few years for budgetary reasons. Such a reduction would especially affect those from the lower income classes who are dependent on life-long supplementary support for the process of accumulating savings and who are particularly affected by a reduced level of the CPS.

In sum, the planned pension reform could indeed result in supplementary savings as a provision for old age. The effects of an increased stock of capital may be positive. On the other hand, the problems and dangers of the planned reform listed above cannot be overlooked. Especially for families with children, this raises the question of whether households are at all able to set aside the supplementary contributions to savings and whether the improvements introduced to the CPS will prove to be enduring. Thus the inequality of the distribution of wealth among the individual types of households described here presumably will not decrease.

From the perspective of social and distribution policy it would have made sense to perform model calculations to check what increases in payments would have been possible in the system of the CPS if the reform would have been done without the voluntary saving scheme for the old age and the generous volume of subsidies had been used instead to subsidize the CPS.

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