Reforming Social Security in Germany – Challenges and Proposals

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Dear Ladies and Gentlemen,

First of all, I like to thank for the invitation and the honour, to speak here. I was asked to tell you about the challenges of reforming social security in German. My speech is structured as follows: In a first step I will illustrate the history and some principles of social insurance in Germany. In a second step I will describe the current social, economic and demographic changes, which have consequences for the functioning of social security in Germany, and the challenges that follow from these changes. Based on these challenges, I will, thirdly, tell you which goals are important for reforms of social security. And, finally, I will discuss, three proposals for reforms that are currently discussed in Germany.

1. Social insurance in Germany

1.1. History of social-insurance schemes

The history of social-insurance schemes in Germany goes back to the German Empire that was established in 1871. The German Emperor and his Chancellor Bismarck found himself compelled to create a social-security net. This did not happen because the Emperor had socialist inclinations or wanted to enable his people to live better lives. The principle goals pursued in setting up the social-security net were to avert the danger that he might lose his grip on power and to pacify the rebellious workers. The introduction of social-insurance schemes was part of what was called ‘worker policy’ (“Arbeiterpolitk”) and merely involved welfare provision for workers and not for the whole population. In this connection, historians speak of a ‘carrot and stick’ policy because the state was simultaneously taking action against the labour movement with the Anti-Socialist Law and repressive measures carried out by police. However, the ‘carrot’ was very modest in quantitative terms and served above all to maintain the supply of manpower.

In November 1881, Chancellor Bismarck presented his proposals for financial arrangements to protect workers against sickness, accidents or invalidity and provide for them in old age. During the years that followed, legislation was used to put in place a social-security net that consisted of the following social-insurance schemes:

- The first, 1883, was 'workers' statutory **sickness insurance**'. Benefits such as sick pay, medical treatment, medicines and aids, hospital treatment, a funeral allowance and maternity benefits were introduced. Sickness insurance was financed one-third by employers and two-thirds by employees.
- This was followed in 1884 by the **accident-insurance laws**, under which insurance holders were provided for in the case of industrial accidents. This insurance was financed 100 percent by employers, which is still today the case.
- The statutory **pension-insurance scheme** was founded in 1889. It put in place a transitional allowance during therapeutic medical treatment, old-age pensions from the age of 70 and invalidity pensions. Pension insurance was financed equally by employers and employees, which, again, still the case today.

In the following decades, the last years of the German Empire and the democratic Weimar Republic (1918-1933), the social-insurance schemes were continued and further developed. Due to the economic depression, hyperinflation and the Second World War, the benefits on offer came to be worth ever less. The value of the capital held by the pension-insurance system fell so dramatically that it was hardly able to perform its functions any longer. With the establishment of the Federal Republic of Germany in 1949 and the subsequent economic boom, it proved possible to improve the economic basis for the social-insurance schemes, which gave them stability and allowed their benefits to be extended.

In 1957, a fundamental **pension reform** entered into force, the principles of which have shaped pension insurance in the Federal Republic of Germany to the present day. Pension insurance was converted from a funded system to a pay-as-you-go system and built up into a comprehensive insurance system based on contributions and wage levels. Another key step was the decision to introduce the dynamisation of benefits. This meant that, from this point on, the level of the pensions paid was linked to the development of gross wages.

Social assistance was introduced in 1962. It operates in parallel to the social-insurance schemes and provides for people who receive nothing at all or draw insufficient benefits from the social-insurance schemes. Social assistance is financed out of taxes, is means-tested and intended to meet basic needs.

1.2. Fundamental principles of the German social-insurance

The German social-insurance is characterised by the fact that it is centred on dependent employment and based on the model of a life-long marriage with a male single earner in full-time employment. These features accord with the objectives adopted by Bismarck and the bourgeois concept of marriage towards the end of the 19th century. However, their fundamental implications still dominate the social-security system in Germany.

The schemes are essentially financed with contributions levied on earnings from dependent employment. There are no contributions on capital income. Only permanent full time dependent workers receive sufficient benefits for old age. Everyone else is only partially covered, if at all – including most of the self-employed, employees who do not earn enough to pay social insurance and part-time workers. Some professional groups of the self-employed have their own social-security systems, while tenured civil servants, for example, receive benefits financed out of taxes. This means that not all sections of the population in Germany enjoy benefits of the same kind and there are also different benefit systems for different groups of individuals.

The level of benefits depends largely on the recipients' previous income from employment. They are intended to safeguard the individual's standard of living. If an individual has paid high contributions into unemployment or pension insurance, they will receive higher benefits than someone who has paid in less. There are no minimum benefits in the social-insurance schemes. Consequently, there is merely a very limited degree of redistribution from top to bottom. Full cover only extends to employees in what are called 'normal employment relationships', which are permanent full-time jobs of dependent workers.

Another defining structural feature of the social-insurance schemes is that they are still based on the standard of a life-long marriage with a male single or main earner who is in permanent full-time dependent employment, while the wife essentially looks after the household and the children. If the income of the 'family breadwinner' stops coming in – whether due to unemployment, invalidity, age, sickness or death – the social-insurance scheme takes its place.

Individuals who have not paid into the social-insurance system have to rely on social assistance, which is financed out of taxation and guarantee a minimum level of income and does not depend on former contributions.

2. Challenges

2.1. Change of family structures

The society of the Federal Republic of Germany is going through radical change in many fields. This is also altering the basic requirements the social-insurance system has to satisfy. One important area of change has been that of **family structures**. It is a long time since the model of the life-long marriage was the only chosen family form. The number of single households, including people living permanently on their own, is rising. As is the number of divorces. Women have become markedly more independent, as a result of which they have increasingly wanted to provide for themselves with financial arrangements that are not dependent on their partners. This development has been accompanied by big rises in the proportion of women in employment.

2.2. Changes on the labour market

Also the labour market has undergone major change over the last few decades. There are ever fewer people who work in so-called 'normal employment relationships', which are permanent, dependent and full time. On the other hand part time work and self employment is increasing, and there are more frequent moves between employers and different types of employment: from dependent to self-employed work and from full-time to part-time, as well as interruptions in employment due to joblessness, phases of further training or childcare.

2.3. Demographic developments

The robustness of Germany's social-insurance schemes is also being tested by demographic developments. These trends are likely to be even stronger in China.

A process is taking place that is termed '**double aging**' in the academic discussion. This refers to the way that, on the one hand, birth rates are falling while, on the other, life expectancy is rising. The implication for our social-insurance schemes is that, if reforms are not undertaken, the number of people paying in contributions will fall and the number of people receiving benefits will rise.

This is not just having an impact on pension insurance, but on health insurance as well. However, the consequences on health care costs are disputed in the academic discussion. On the one hand, some academics adhere that costs will rise due to the fact we are living longer and this results in a higher demand for medical services, which are getting ever better, but also more expensive. On the other hand, some academics argue that most costs are incurred shortly before death and the fact that we are living longer will hardly increase the expenditure borne by the sickness-insurance system. The results of empirical studies on this topic are not unique in direction and it is not clear which thesis is more appropriate.

As far as **pension insurance** is concerned, it is relevant, that the ratio of elder people to people in working age, is rising. However, this is only one factor that affects the financing and the expenses of the pension-insurance. More exactly, it is the development in the number of people paying contributions that is of fundamental significance, and not the number of people who belong to a certain age cohort. And this can be managed politically to some extent by raising the pension age, by increasing the proportion of people in employment and by immigration policy. Equally important is the development of the incomes on which contributions are levied. The return of a pay-as-you-go pension insurance is equivalent to the rate at which the national wage bill grows. In other words, the return is determined by two factors: by the change in the number of people who pay contributions and, secondly, by the rate at which the income, that is the basis of the contributions, is going up. Since it is possible to reckon with increases in productivity, which will lead to corresponding increases in wages, it is also to be expected that, from this point of view, the overall effect of demographic developments will turn out not to be as dramatic as the double aging would suggest. If growth rates are strong, it will be possible to more than compensate for these demographic effects.

2.4. Growing significance of income from assets

In recent years, wages and salaries have fallen markedly relative to income from assets. It also means that the basis for the funding of social-insurance schemes has become smaller. As I mentioned earlier, the return of a pension insurance under a pay-as-you-go system depends on the growth of the national wage bill, and the return in the German pension insurance system is therefore falling as well. One possible way of circumventing this problem is to incorporate income from assets into financing of the social-insurance schemes. So, my advice would be to feed income from assets, which will further rise in the future, into the system and not only earnings from dependent workers.

2.5. Poverty and distribution

Poverty is encountered even in a rich country like Germany. However, this is not comparable with the absolute poverty that is to be observed in many developing countries. But relative poverty is also problematic. We speak of relative poverty when the income is too low to take part in the normal social live in a particular country. Relative income poverty leads to social exclusion. In 2005, 18 percent of the population in Germany fell below the European relative poverty line, which is 60% of national median income. This figure has increased by 50 percent in the last 10 years. Fighting poverty is therefore an important challenge for social policy in Germany.

In this respect, our goal should be for everybody to be able to participate in social and cultural life. This is important not just for reasons of social policy, but also out of economic considerations and on grounds of social cohesion. Social exclusion can ultimately threaten social peace.

China's economic growth is certainly making a decisive contribution to the reduction of absolute poverty. However, these processes will also focus attention ever more on the question of distribution. In the future, it would be sensible to make relative poverty a priority for the struggle against poverty in China too and to have the distribution of incomes in mind when social-security systems are being conceived. More than 2000 years ago, in his work *The Laws*, the famous Greek philosopher Plato said: ‘‘The limit of wealth for the highest class that may not be exceeded should be four times the value of the land allotted to each citizen; the lower limit of poverty should be the value of such an allotment, and indeed it should not be permitted for this to be reduced. Whoever acquires more than lies within the delineated limits, by whatever means, shall have to consign this surplus to the state.’’

3. Goals for future social security reforms

In response to these challenges, the following four goals therefore need to be mentioned when we think about reforms to social security in future.

Firstly, social security should be universal. The whole population has to be integrated into the social-security system – and not just employees as until now.

Secondly, we need an individualisation of social insurance entitlements. The society is responsible for each member and, thus, each person should receive its own social security and every single individual must be insured in its own right.

Thirdly, the sources of financing the social-security systems need to be placed on a broader basis. Until now, in Germany only income from employment has been incorporated into the financing arrangements. The goal must be for all types of income – including income from assets – to be incorporated into the funding system. This would ensure a permanent, stable flow of financial resources. With this goes that upper income groups would be required to take greater responsibility. The burdens on lower income groups would be lessened.

Fourthly, social-insurance schemes must be supplemented with elements that provide a minimum level of security, which would have to ensure it were possible for people to take part in social and cultural life.

4. Proposed solutions

After I discussed challenges and goals of reforming social security, I will, finally, discuss three proposals, that are discussed in Germany. My suggestions are not necessarily the opinion of the majority in Germany. However, to my point of view, they are very important for societies, scientist and politicians, who think about the design of social security to face the current challenges.

4.1. Funded versus pay-as-you-go

On account of demographic developments in many industrialised countries, it is frequently proposed that systems of provision for old age based on the pay-as-you-go system – which are not just to be found in Germany – should be converted to, or at least partly replaced by, a funded system.

The assertion made is that the funded system is not, or at least not as, susceptible to demographic developments. However, this is incorrect because of course also under the funded system ***people*** need to use the capital to generate prosperity, which is then available to finance pensions. In consequence, if there are fewer economically active people, this inevitably has an impact on a funded system as well.

The second argument for a funded system is that the introduction will expand a country's capital stock, as a result of which its productive capacities will also be enlarged. This is correct in principle because under the pay-as-you-go system the revenues that flow into pension insurance are spent again straight away, while under the funded system they are saved and, if it is assumed that all other factors remain constant, savings should increase across the economy as a whole. However, it may be that some of these savings simply replace other private savings, which may reduce the impact this has. A funded system will increase the supply of capital, but not necessarily the demand.

Finally, it is suggested that the average return of the capital markets is higher than the return of the pay-as-you-go system. The advocates of this argument cite average returns in the past. However, it is not so clear whether similar returns will also be achieved in future. If the capital stock increases, the marginal earnings on capital will fall and returns will therefore go down as well.

At this point, it is often objected that, in a globalised economy, the additional capital could be invested in developing countries, for instance, where it would be possible to expect higher returns on account of their potential for growth. However, this is only the case if these opportunities are exploited by a relatively small country (a 'small open economy' as the economists say). By contrast, if a large country such as China or many countries – and the conversion to capital funding is being discussed in almost all the industrialised states – convert their provision for old age wholly or even just to a large extent to capital funding, there will a real danger that returns of capital fall significantly overall.

When the returns achieved by the pay-as-you-go system and the funded system are compared, the conclusion that the funded system is better for an ageing population, which is plausible at first sight, therefore proves on closer analysis not to be quite so clear-cut. But even if the average return under the funded system were greater – which might be the case - than under the pay-as-you-go system, we would still have to deal with the problem that capital returns are considerably more insecure, as is startlingly evident from the current crisis on the financial markets. A capital stock can melt away very rapidly as a result of environmental disasters or economic crises. Even if such major negative events are disregarded, capital market returns are simply characterised by an extremely high level of volatility. Apart from this, the pay-as-you-go system is also capable of coping with massive upheavals. For instance, German unification was by no means a problem for our system of provision for old age, which would not have been the case if we had had a funded pension-insurance system.

When the advantages and disadvantages of the two systems are weighed up, everything suggests that a basic level of provision and measures to ensure a certain minimum standard of living should be put in place by means of a pay-as-you-go or a tax-financed pension on which people could rely. At most, the funded system should complement the pay-as-you-go system as a way of gaining returns that might be higher. However, it should not be forgotten that anyone who invests in capital may not gain any return.

4.2. Citizens' insurance

Until now, the German social-insurance schemes have been designed for people in employment and are financed only by earnings. A discussion is currently going on in Germany about the possibility of transforming pension and health insurance into a citizens' insurance. Citizens' insurance can be defined as a system in which all a country's citizens are covered and contributions are paid on income of all types, including income from capital. This would provide universal insurance for all citizens, while its financing would be placed on a broad basis, something that would ensure it was financed sustainably and equitably. The contribution rates for social-insurance schemes, which are very high in Germany, would fall.

4.3. Basic income

Another reform proposal that is being debated very intensively in Germany is the basic income, which is also known as the 'citizens' income' (Bürgergeld) in the German discussion. This idea was also supported by three Nobel Price Winners for economy, who come from very different economic schools: the neo-liberal Milton Friedman, the social-liberal James Tobin and James Meade, which one of my professors called an 'intelligent socialist'.

The idea of a basic income is that each member of society receives regularly a sum of money from the state that is the same for everyone.

Such a basic income would not be additional to the income citizens currently receive, but a kind of advance payment that would ensure people had a certain minimum stake in society from the outset.

A basic income would replace the tax allowances people are able to set off against income tax, and a basic income is an alternative to means-tested benefits. Means tested benefits are only paid to those whose income and assets are inadequate to pay for their own living expenses. State authorities therefore have to examine claimants' incomes, assets and housing situations, which requires considerable bureaucratic effort.

Thus, a basic income would genuinely reach all people in need in an unbureacratic fashion. If the basic income is high enough, it could even completely eradicate income poverty. In addition to this, a basic income would strengthen societal cohesion because everyone would receive it and no one would be excluded. At the same time, it would be financed collectively by all members of the community – with every citizen contributing as much as their resources permitted. Last, not least, a basic income would also be a way of pursuing economic goals. Incentives to work will increase and it would reduce economic risk, which would lead to higher productivity. Lower levels of risk would foster an increased willingness to work to make investments and to promote individual innovativeness and creativity.