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Commentary

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GERMAN PENSION REFORM*

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It is a great pleasure to be back at Brooklyn Law School, and it has been no less of a pleasure to listen to the excellent paper presented by Professor Lothar Schruff. As I agree with everything he has said, there is no reason to respond. All I want to do is to add two observations to the need for, and the problems of, reform in Germany.

First, the aspirations for serious reform have to be seen in the larger context of changes in basic economic and social structures in Germany. This can be best explained by referring to the very interesting phenomenon of the direct pension commitment made by a firm to its employee. This has been an important element of industrial recovery since World War II. First of all, it was a wonderful instrument of corporate finance. As wages were low, it can be said that part of employees' earnings were kept within the firm and paid out only after retirement. They constituted funds which could be used for self-financing. On the balance sheet they were liabilities;

 The following discussion is presented in its original transcript format, with minor editorial changes by the Author.

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therefore, they were subject neither to taxation nor to shareholders' claims for dividends. It was long term debt used by management to rebuild German industry.

At the same time, the pension commitment provided incentives to form human capital within the firm. Workers stayed until retirement; they were interested in the future of the enterprise and dedicated to their jobs. It was worthwhile to spend resources on their education.

More recently, and for a number of reasons, this system has come under considerable stress. Wages are no longer low in Germany so the pension commitment is a liability which adds to the price of labor—which is among the highest globally. Since we see more bankruptcies, it has become obvious that the system of direct pensions has shifted additional insolvency risks to employees. They lose not only their jobs but also their pensions. For this reason, the insurance system, which has been explained by Professor Schruff, has been introduced. With the recession, however, corporate failures have increased; therefore, premiums have gone up and become a burden for corporate firms.

In addition, while employees' interest in the firm may have declined with the insurance system, at the same time there is more mobility among workers. For these reasons human capital is no longer served by the system. Finally, corporate finance has changed. The German department market has recovered, the equity market is slowly improving, and German corporations have access to the internationalized financial markets. Thus, self-financing is no longer needed; and it is no longer thought to be an efficient method to provide funds for investment.

Now to my second observation. I think the obvious way to proceed for Germany is to move towards defined contribution pension funds similar to American or U.K. style. The big problem for the moment, however, appears to be tax. The general rule in Germany is that you are taxed for your income even if you invest it individually in order to secure your post retirement income. But there is one important exception—life insurance. To a certain amount, life insurance premiums can be deducted from taxation; even the later payment by the insurance company enjoys some tax benefits. It is generally assumed that pension funds will not be sufficiently attractive if they are not allowed to enjoy comparable tax advantages. That is to say: the tax benefits of life insurance should be extended to pension funds.

This proposition is a source of conflict between the insurance and the banking business. The insurance companies want to run the pension funds as benefit defined funds, and they argue that tax advantages should be extended only to their funds. The banks plan to offer contribution defined funds, and they argue that the tax benefits should be equally granted to those programs. In addition, Germany faces considerable budget problems. We experienced difficulties meeting the standards for monetary union in Europe. It is generally assumed that we need a tax reform in order to meet the challenges of global competition. However, lower rates of individual and of corporate income tax will not be possible without cutting back on government expenses, including tax subsidies. So there exist two conflicting policy objectives. For the moment, I do not see how this will be resolved. The outcome of the federal election in ten days may have an impact, but neither side has clearly indicated so far what they will or would do.