Pension Reform in Germany

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Key issues of the pension reform

On May 11, a clear majority of both chambers of the German parliament adopted a profound modernisation of the old-age security system. The purpose of the pension reform is to make the system of old-age security sustainable and to adjust it to the anticipated challenges associated with demographic development. The challenge is to ensure that the old-age security system is safe and affordable in the long run. This means: not to overtax present and future contributors and to keep the benefit ratio also for future pensioners at an adequate level.

By this reform, a pension system is implemented which guarantees safe and adequate pensions, while preserving solidarity and justice within and between generations, however, without thereby destabilising public budgets or overstraining future generations.

Since the old-age pension insurance system was set up in Germany more than 100 years ago, it has been financed from equal contributions paid by the employees and employers plus a subsidy from tax funds. Federal subsidies account for approx. one-third of all income generated by the old-age pension insurance.

In order to compensate for loss in confidence, one of the first decisions of the new Federal Government was to change the former system of financing general public duties by the contributors. In the scope of the ecological tax reform, it was ensured that those benefits paid by the pension insurance which are not covered by contributions, should be financed from the federal budget.

The number of persons insured declined in the past as a result of undesirable trends. For example, numerous employments were divided into so-called “marginal” employments, which are exempt from social insurance. In other cases, employees became formally self-employed in order to avoid compulsory insurance, and thus payment of contributions. Such fictitious self-employed persons normally had a single customer only. The Federal Government has taken measures to fight this undesirable trend. For example, even people in “marginal” employment are now subject to compulsory insurance, and the insurance carriers examine on the basis of a catalogue of criteria whether or not fictitious self-employment is present.

The decline in the number of persons covered by compulsory pension insurance has to be stopped safely in order to ensure that solidarity and the contract between generations continue to work. By taking all these measures, the contribution rate to the pension insurance of 20.3% still applicable in early 1999 could be reduced to 19.1% today.

The pension policy measures already taken then formed the basis for a sustainable reform of the pension insurance, which accounts for the long-term interests of the generations of pensioners today and in the future.
Aims of the reform

The purpose of the recently adopted pension reform is to make old-age security sustainable, and to adjust it to the consequences of demographic development. Demographic development has been characterized by a strong decline in births in Germany, but also in most other European countries, since approximately the late nineteen-sixties/early nineteen-seventies. Demographers therefore anticipated that each birth cohort would be smaller in number than the previous one, as shown quite clearly in the forecast for the year 2050 in Fig. 1. Furthermore, life expectancy, especially of women, has grown strongly, and is expected to grow further, which is in itself a rather positive development. However, this development has certain consequences for the average term of a pension and created the need for political action, which was satisfied by the Federal Government by adopting its pension reform. Special emphasis was also placed on maintaining the social role of old-age pension and extending it further.

This policy will have sustainable long-term effects in the course of the next approx. 30 years, and the contribution rate to the old-age pension insurance will be kept at a level which will not overstrain the generation of the gainfully employed. At the same time, it will be ensured that the wage replacement benefits organised by the government for the generation who is no longer working will reach a level that guarantees almost the same standard of living as had been attained during working life.

Another aim of the reform is to facilitate compatibility between gainful employment and child raising, especially for women, and to provide a specific compensation for child-raising periods in employment histories.

In 2030, the income replacement ratio will be between 67 and 68 per cent. The contribution rate will remain below 20 per cent until the year 2020, and will not rise above 22 per cent by the year 2030. The income replacement ratio is the ratio between a pension paid to a pensioner on the basis of 45 years of insurance at an average income level and current average earnings. Pensions will be calculated on the basis of the entire time period between 17 years of age and the beginning of pension payments, therefore, individual income replacement ratios will regularly differ from this value.

The long-term stability of the contribution rate to statutory pension insurance is one fundamental condition of restoring confidence in the viability of old-age pension insurance. Furthermore, a stable contribution rate is essential for limiting the wage-related cost, and thus for strengthening and protecting the overall economic framework, especially international competitiveness. This is an important prerequisite of increased growth and employment and for protecting Germany as an industrial location.

The following table shows a model of how the contribution rate, the income replacement ratio from compulsory old-age pension insurance, and additional pension benefits from private provision or occupational pension schemes as well as the overall income replacement ratio comprising statutory pensions and private provision will develop in the long run.
Promoting additional, capital-funded provision for old age

This pension reform includes an element with a novel quality, namely, the introduction of a voluntary, capital-funded provision for old age which complements the statutory old-age pension insurance. Building up this private or occupational provision for old age is massively promoted by governmental subsidies, which are particularly designed to support those with a lower income and families with children. Special incentives to make provisions will be given especially to these groups of persons.

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<td>Gross capital-funded pension*</td>
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Notes: (*Columns applicable to new pensioners in respective year)
- Expenses for old-age provision rise from 1 per cent in 2002 to 4 per cent in 2008 every two years by 1 per cent
- Effect of adjustment is smoothed in steps of 0.5 per cent
- Investment at a tentative interest rate of 4% p.a.
- Gross capital-funded pension is adjusted at the same rate as pension from statutory old-age pension scheme
In total, approximately EUR 10 billion will be provided by the year 2008 for promoting additional provision for old age.

The law on additional private provision for old age will be come effective on January 01, 2002. The compulsory insured will thus have sufficient time to obtain information on suitable investments for old-age security. The social partners are also given the opportunity to review and, if necessary, adjust the occupational pension schemes or enter into new collective agreements under no pressure of time. Financial institutions may develop new financial products and prepare the market within a reasonable time frame.

**Beneficiaries**

The beneficiaries of this reform include all those paying compulsory contributions to the statutory pension insurance. Also included are, in addition to workers and employees, disabled persons working in workshops, insured during creditable child-raising periods (duration: 3 years after a child is born), persons providing care, in military or civilian replacement duty, etc.

According to the legislative intent, officers and employees in public service will be included in the promotion, provided that the reform is applied to them with equal effect, followed by a reduction of their income replacement ratio.

**Principles of promotion**

Contracts for old-age provision have to satisfy certain criteria in order to receive promotion. In its capacity as certification authority, the Federal Supervisory Office for Insurance Associations will examine in advance whether the products for old-age provision offered on the market satisfy the statutory criteria for promotion. The certificate expressly is no government proof of quality confirming the quality of the product with regard to profitability and protection. The financial service providers, or their federal associations, may be issued a certificate for model or individual contracts by the certification authority which confirms that their product complies with the government promotion criteria, and is therefore eligible for promotion by way of a bonus or a tax relief.

- Eligible for promotion are those investments which are preserved until age 60, or until old-age pension is paid to the investor. Policy loans or pledging are not possible.
- From the beginning of withdrawal, the investments must guarantee a life annuity of equal or rising amounts; alternatively, suitable withdrawals from funds or bank deposits will be possible which revert to a life annuity at the age of 85 years.
- When the withdrawal period begins, at least the nominal value of paid contributions and during withdrawal the current monthly payments have to be guaranteed. The investment contracts may be combined with a disability pension and/or a survivor’s pension without being disqualified from promotion. During the
accumulation period, the investments are exempted by law from attachment or an offset against social or unemployment assistance.

**Investments qualifying for promotion**

Investments qualifying for promotion include occupational pension schemes, such as direct insurance, Pensionskassen and pension funds (provided that the eligibility criteria of investments are satisfied and contributions are made from individually taxed earnings from work subject to compulsory contribution) as well as pension insurances, funds and bank savings plans as private, capital-funded provision for old-age. Funds and bank savings plans have to be combined with payment plans and a mandatory annuity for the highest age phase. Even existing contracts may be included in the promotion if they satisfy the conditions for qualified investments.

**Inclusion of home ownership**

In order to promote home ownership, the law stipulates that an amount in between 10,000 and 50,000 Euro may be withdrawn from the investment in order to build or purchase a home for own use within Germany without losing eligibility to promotion. The amount withdrawn has to be repaid into a certified old-age provision policy until completion of 65 years of age.

**Concept of promotion**

The annual contributions for old-age provision are comprised of private contributions and subsidies. The insured will only pay his/her own contributions, the state subsidy will be paid directly into the promoted contract at the request of the insured. The amount of the subsidy depends on the personal status and number of children. Furthermore, the entire amount of old-age provision may be alternatively deducted from taxes if this is more favourable.

A tax relief may be claimed for the following amounts of old-age provision (individual contributions + subsidy) regardless of the individual income:

- in the assessment periods 2002 and 2003 up to 525 Euro
- in the assessment periods 2004 and 2005 up to 1,050 Euro
- in the assessment periods 2006 and 2007 up to 1,575 Euro
- in the assessment period 2008 and thereafter annually up to 2,100 Euro

Old-age provision is accumulated from non-taxable income, or from taxable income plus subsidy. Therefore, all payments made at old age are fully taxable.

**Amount of subsidy**

The subsidy is composed of a basic subsidy and a child subsidy. The basic subsidy amounts to
in the assessment periods 2002 and 2003 38 Euro
in the assessment periods 2004 and 2005 76 Euro
in the assessment periods 2006 and 2007 114 Euro
in the assessment period 2008 and thereafter annually 154 Euro

In the event of joint assessment of spouses, each of them is individually entitled to the basic subsidy if both spouses earn independent pension credits. The same applies if only one spouse has a taxable income that is subject to mandatory insurance, but pays his/her own minimum contribution (cf. below).

The child subsidy payable for each child amounts to

- in the assessment periods 2002 and 2003 46 Euro,
- in the assessment periods 2004 and 2005 92 Euro,
- in the assessment periods 2006 and 2007 138 Euro,
- in the assessment period 2008 and thereafter annually 185 Euro,

if

- in the assessment periods 2002 and 2003 1.0%,
- in the assessment periods 2004 and 2005 2.0%,
- in the assessment periods 2006 and 2007 3.0%,
- in the assessment period 2008 and thereafter annually 4.0%,

of the income of the previous year liable to pension insurance have been invested; at maximum, however, the amounts mentioned above will be applicable, for which a tax relief can be claimed.

Even in case that the subsidies by themselves correspond to the 4% contribution rate, or even exceed it, a certain base amount has to be paid as minimum individual contribution in order to obtain the full subsidy. This minimum individual contribution equals the following minimum sums in the assessment periods starting from 2005
- 90 Euro for tax payers not entitled to child subsidies
- 75 Euro for tax payers entitled to subsidies for one child
- 60 Euro for tax payers entitled to subsidies for two or more children

This provision is designed to avoid payment of subsidies without own contributions.

**Examples:**

A married couple with one income and two children and a gross income of 25,000 Euro will receive a state subsidy of 678 Euro (154 Euro + 154 Euro + 185 Euro + 185 Euro) annually in the year 2008 in return for own contributions of 322 Euro, thus achieving an annual investment of 1,000 Euro (= 4% of 25,000 Euro).

A single mother, gainfully employed with one child, who does not obtain an income subject to pension insurance during child-raising leave, will receive a state subsidy of 339 Euro (154 Euro + 185 Euro) in the year 2008 while paying the minimum contribution of 75 Euro annually, so that her investment amounts to 414 Euro. In this case, the state subsidy accounts for more than 80% of the total investment.
Strengthening occupational pension schemes

Improvement of framework conditions

Occupational pension schemes will presumably play a far more prominent role in the future than ever before in order to earn an additional pension. By the introduction of the new promotional scheme the framework conditions of occupational pension schemes were considerably improved. Collective agreements will provide a broader basis for entire industries. The social partners will gain more responsibility in this area.

Entitlement to occupational old-age provision

In the future, employees will be personally entitled to an occupational old-age pension, which will be payable from their income, by waiving certain parts of the income, e.g., a part of the Christmas bonus or holiday pay, or payment for overtime worked, and having the employer pay this money into an occupational pension scheme (remuneration conversion). As far as a claim for remuneration is based on a collective agreement, the remuneration can only be converted if this option has been provided for in the collective agreement or is at least permitted by the collective agreement (by way of industrial agreement or an individual agreement). For employees and employers covered by a collective agreement, an employee-funded occupational pension scheme by way of remuneration conversion is always subject to the collective agreement.

Occupational pension schemes by way of remuneration conversion are put into practice by way of an agreement between the employee and the employer. Such an agreement can be made on an individual, company, or collective basis.

Vesting and carrying of credits

Vesting of occupational pension credits means that once an occupational pension credit has been earned, this credit is not lost, even if the employment is terminated prior to payment of the occupational pension, for example, because the employee changes employers. The credits earned by converting parts of the remuneration become immediately vested by law. Furthermore, the general statutory time limits applicable to vesting of pension credits are reduced from 10 to 5 years, and the age limit is lowered from 35 to 30 years of age, if a pension commitment was exclusively financed by the employer. The conditions of mobility of the workforce are improved by this measure, because it becomes easier to carry pension credits earned from one employer to another. These shorter time limits are of special benefit for women many of whom used to lose their occupational pension credits because they interrupted their gainful employment in order to raise children.
**Introduction of pension funds**

The aim to include occupational provision for old age into the new promotional scheme of subsidies or tax reliefs is facilitated by the introduction of pension funds. The possibility of qualifying pension funds as segregated assets is a new possibility for companies to set up their balance sheets according to USGAAP, and thus to improve their standing at the international capital markets.

Employees benefit from a legal claim against the pension fund as an external entity managing occupational pensions and from carrying their pension credits to a new employer.

Furthermore, by setting up pension funds, employers can calculate their contribution commitments and guaranteed minimum amounts contributed to the occupational pension scheme more easily without having to assume long-term liabilities in the form of payment guarantees which are associated with higher risk. Pension funds will pay old-age pensions for the whole life, and offer the possibility of covering the risk of disability and survivor’s provision. Since the contributions paid to pension funds are fully tax-free, the pensions derived therefrom are fully taxable (later).

Greater freedom of investment offers the pension funds the opportunity to manage capital investments according to international standards in order to obtain an improved ROI, increase the efficiency of occupational old-age provision and reduce its cost. Monies invested to build up an old-age fund are guaranteed by the supervisory agencies who monitor the operations and equity capitalization (solvency) of the funds. Furthermore, funds are protected against insolvency by the Mutual Benefit Association for Pension Security for the pension funds.

Pension funds will strengthen Germany’s position as a financial centre. Due to the rather long-term character of investments, the pension funds will mostly rely on real values, such as stocks and other participating interests, which will provide an additional impetus to the capital market, and thus also to growth and employment.

**Tax- and contribution-free accumulation of capital**

Occupational pensions were originally financed by the employer alone. For some time, however, they have been increasingly funded by a conversion of the employee’s remuneration. Saving contributions to the social insurance and tax reliefs are meant as an incentive for employees and employers alike. In order to avoid negative effects on the contribution income of the social insurance, thus reducing future claims or credits, this possibility will be abandoned in the medium term. Therefore, the tax- and contribution-free conversion of remuneration in occupational old-age provision will no longer be possible after late 2008.

**Return to wage-oriented pension adjustment**

One characteristic feature of the German pension insurance, which dates back to the 1950s, have been annual pension increases at the same rate as the wages. Although pensions are adjusted annually or in longer intervals in other countries, too, the
amount of such adjustments is usually lower than the rate of wage increases. In the year 2000, the principle of adjustment according to wages was abandoned, and pensions were only increased at the rate of price increases. This measure was designed to ensure that pensioners assume an appropriate share of the loads anticipated to be faced in the future. By returning to wage-oriented pension adjustments as of July 1, 2001, pensioners will be able to participate in the economic growth again, as reflected by the development of the wages.

Changes in the deductions from employee earnings, which do not affect provision for old age, will not be considered by the new adjustment formula. This provision refers to changes in deductions for unemployment insurance and the influence of taxes on income. Since an adequate standard of living at old age can only be ensured through additional provision for old age and its government support, a core element of the reform, payments for the additional private provision for old age will be accounted for in the adjustment formula. As of 2011, the formula will subject the existing pensions as well as future pensions to the necessary savings by flattening the pension increase in order to provide a moderate ceiling to additional expenses of the statutory pension insurance resulting from the growing number of elderly people.

**Improvement of old-age security for women**

An increasing number of women wants to combine family, children, and employment. The pension reform also improves the framework conditions for enabling women to realise their life plan.

Therefore, in the course of the pension reform

- lower earnings during child-raising phases will be revalued upward when calculating pensions, in addition to the pension-increasing consideration of three years of child raising, and

- a compensation will be provided to women who were not even able to take up part-time employment for having raised at least two children,

- child-raising periods will increase pensions for survivors.

Furthermore, pension credits earned during a marriage can be shared equally by both spouses through the new pension splitting option.

In detail, the following measures were adopted:

**Child-related upward revaluation of contribution times when calculating pensions**

In order to mitigate the consequences lower earnings have on pensions, the pension credits of child-raising persons who are gainfully employed during the first 10 years of life of a child, but mainly work part-time and therefore earn less than average, will be revalued upward for time periods starting from 1992. The individual earnings will be increased by 50% to a maximum of 100% of the average income, if a total of 25
pension-earning years are present. This will be an incentive to keep the gaps in the insurance history caused by child-raising times as short as possible, and to at least work part-time soon after the child-raising time. Especially those women who take up part-time employment as soon as the youngest child is admitted to kindergarten will benefit from this provision.

This favourable treatment will also be beneficial for those persons who cannot take up an employment at all, or no full-time employment, because they raise a child in need of special care. Again, the compulsory contribution time as of 1992 will be revalued upward by 50% - but at maximum to the value equivalent to 100% of the average income - until the child in need of special care has completed 18 years of age.

Compensation for raising several children

Persons who normally cannot even take up part-time employment because they raise two or more children at the same time, and are therefore not entitled to an upward revaluation of contribution periods, will be credited earnings points for the time after the creditable child-raising periods (i.e. as soon as the child has reached 3 years of age) until 10 years of age for the year 1992 and later. This credit will normally correspond to the maximum possible promotion of child-related upward revaluation of contribution periods for gainfully employed persons raising children (i.e. one-third earnings point per year). One earnings point corresponds to the pension for 1 year of employment with an average income (as of July 1, 2001, Euro 25.31 per month in the old German states, and Euro 22.06 per month in the new German states).

Example:
A woman has 3 children, the children were born in late 1990, late 1992, and late 1994. She is not working. The new provision will increase this woman’s monthly pension by Euro 33.

All child-related benefits (including the child-raising periods to be considered) will increase the woman’s monthly pension by Euro 207.

Reform of the survivor’s pension

In the future, child-raising periods will also be considered in the calculation of survivor’s pensions. The general income replacement ratio underlying the widow’s/widower’s pension will be slightly reduced from 60% to 55%, but at the same time, the pension will be increased by two earnings points for the first child and one earnings point for each additional child. This reassessment in the field of survivor’s pension is justified because women who raise children have far larger gaps in their earnings history than men and women who did not raise any children. Thus, even a widow with an average widow’s pension who raised just one child will experience a slight improvement. Combined with the upward revaluation of her own contribution periods, the overall provision for women who have raised children will be substantially improved in most cases.
Furthermore, existing injustice with respect to earnings offset against survivor’s pensions will be eliminated. In the future, the offset will apply to all types of income (including income from investment), because the previous limitation to income from employment, pension insurance and pension plans - the typical income of the lower-class - was no satisfactory solution in terms of social policy. However, the pensions payable from the new additional old-age provision schemes to be promoted, which are exactly designed to ensure an acceptable livelihood in combination with the compulsory pension, will be excluded from such offset.

Income offsets will remain permanently dynamical, i.e. the child-related exempt amounts as well as the basic exempt amounts will be adjusted annually at the rate of the pension increase.

The reform of the survivor’s pension will be restricted to married couples where both partners are below 40 years of age in order to safeguard long-term trust and confidence. This provision will account for the fact that all older couples have based their life plans on the former provisions, and that changing their life plan will be extremely difficult for these persons. The forthcoming limitations (e.g. the offset against all types of income) will therefore be applicable in the long run only, and will not take effect before the share of gainfully employed women has increased further and the importance of survivor’s pensions will most likely have decreased and yielded to an independent old-age provision of women.

The widow’s pension for women who do not raise any children and who are below 45 years of age (so-called small widow’s pensions) will be limited to payment during a transitional period of 2 years. When the widow has reached 45 years of age, she will be entitled to regular widow’s pension.

**Pension splitting among spouses**

In order to enhance the independent old-age provision of women, younger spouses will be given the opportunity to share their pension credits earned during the marriage on an equal basis. Instead of the traditional provision for married and widowed persons (as long as both spouses are alive, each of them receives his/her own pension, and when the first spouse dies, the survivor will receive a subsidiary, derived survivor’s pension in addition to his/her own pension), pension splitting of the pension credits earned jointly during the marriage can be achieved by a concurrent declaration of both spouses. Sharing pensions on an equal basis will normally have an effect while both spouses are alive (if a full old-age pension is paid to the second spouse, too). Pension splitting actually increases the pension benefits payable to women, which are not subject to income offset even in the event of death of the husband, and which are not forfeited in the event of re-marriage.

However, pension splitting will only be performed if each of the spouses can prove at least 25 pension-earning years in order to avoid unjustified enrichment of persons whose focus of old-age provision lies outside the statutory pension insurance.
Closing pension gaps in the beginning of an insurance history

The old-age provision of young insured with breaks in their employment histories will be improved. Like the times spent on school education, which are normally earlier than gainful employment, times of illness and of youth unemployment before taking up the first employment will be considered. Thus, in particular, in the event of premature disability or early death the insured himself/herself as well as his/her survivors will experience significantly higher pensions.

Improvement of the information service of the pension insurance funds

In the future, the pension insurance funds will communicate their insurance status to all insured over 27 years of age every year without being specifically requested. Thus, all insured will have the opportunity to review their individual decisions with respect to the development of capital-funded old-age provision and to optimise their investment strategy with regard to the level of provision desired to be attained at old age. Furthermore, the pension insurance funds are given the opportunity to provide information which will serve as guidance for building up capital-funded old-age provision.

Basic protection according to need

Particularly elderly people often do not claim the social assistance they are entitled to, because they are afraid the welfare offices might take recourse to their children with respect to their support. This main reason for bashful old-age poverty will be abolished by the basic provision introduced in the course of the pension reform:
- Persons over 65 years of age, or over 18 years of age if permanently and fully disabled for medical reasons, are entitled to basic protection.
- The benefit depends on the need. Income and property are to be considered, as for payment of social assistance. However, no recourse for support will be taken to children or parents with an annual income of less than Euro 100,000, if their relatives claim basic protection.
- The basic protection benefits will be equivalent to the assistance to livelihood granted to persons outside institutions in accordance with the Federal Social Assistance Act, and one-time benefits will be payable on a lump-sum basis.
- Basic protection will be the responsibility of the districts and free cities.
- The pension insurance funds are obliged to inform and advise everyone entitled to basic protection on the criteria for eligibility to benefits under the new law, and to assist them with their application for basic protection - also by relaying applications to the agency in charge of basic protection.
- Basic protection will be tax-funded.

Basic protection will make it much easier for elderly people to enforce their rightful claims. Furthermore, the living conditions of persons with a reduced earning capacity will be significantly improved, in particular, for those who have been most severely handicapped from birth or early youth.
Reform of pensions for reduced earning capacity

Some parts of the pension reform already came into force on January 1, 2001. They referred to a correction of unsocial interventions of the previous government in the field of pensions paid to persons with a reduced earning capacity.

The previous classification of pensions for reduced earning capacity into occupational disability pensions and general disability pensions will be replaced by a two-step pension for reduced earning capacity the amount of which will depend on the remaining capability of the insured.

- A pension for reduced earning capacity will be paid even if the insured has retained some of his/her earning capacity, if the labour market does not offer suitable employment. Thus, recourse to unemployment assistance or social assistance will not be necessary when the entitlement to unemployment benefits ends.

- Persons insured who have completed 40 years of age upon the implementation of the reform will continue to be entitled to a partial pension for occupational disability.

- Deductions will be made from all pensions paid if an insured wants to quit employment prior to 65 years of age. The deduction amounts to 0.3% for each month a person retires before having reached 65 years of age.