

THE PRIVATE 'ECONOMICS OF LIFE' AND THE INFLUENCE OF THE STATE

New Strategies for Wealth Accumulation

Ulrich Pfeiffer and Reiner Braun

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based upon an empirica-study on behalf of the German Institute for Retirement Provision (www.dia-vorsorge.de)

An analysis of age distribution in the German population shows that simply diverting or adjusting the transfer streams will not be a sufficient measure to master the consequences of ageing. For private households, there will need to be very drastic changes in savings habits, patterns of consumption, use of capital and what people do during their lifetimes. The Germans don't save enough to be able to afford so few children, or else they raise an insufficient number of children for them to get away with saving so little. The state must facilitate new patterns of behaviour and encourage those people who are in work to take more responsibility for themselves.

The necessary security for old age is achievable. Despite the consequences of an ageing population following decades of low birth rates and a potentially rampant pessimism about the future, this analysis presents a hypothesis to the contrary, that the 'Economics of Life' of individual households can be organised very much more efficiently and methodically, so that the provisions that now need to be made are achievable without incurring unreasonable hardship - at least for the next 30 years. This hypothesis may cause surprise. But a longer working life from shorter times in education, the abolition of national service, higher employment rates and later retirement would by itself lead to decisive improvements in the creation of income. The opportunity to save would be significantly improved. Improvements are also possible in the utilisation of earnings - especially by creating more affordable homes through deregulation in the relevant markets. Private households face fundamental challenges, and government policy must become their partner in restructuring the 'Economics of Life'.

Table 1: Controls for the ‘Economics of Life’ available to Private Households and the State

Private Households	State
Lengthen the working life	
- scope of participation in paid employment (per day, at various times of life)	- final school certificate in the 12 th year
- Age at retirement	- reduce time as a student
	- abolish national service
	- improved child care
<i>=> more time for saving, shorter time without an income</i>	
Increase savings for old age	
- save more	- more deferred taxation
- work longer	- reduce taxes and deductions
- work more productively	- more flexible Riester savings
<i>=> saving smoothes consumption during the transition into retirement</i>	
Increase life-long income	
- work more productively	- improve education
	- encourage growth of families
<i>=> higher real incomes enable higher savings rates without reducing current standards of living</i>	

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Table 2: Assumed basic conditions for building an asset base – today and in the future

	Meier I (Senior)	Meier III (Grandchild)
Year of birth	1943	1985
Year of retirement at 60	2003	2045
Property (own home, owned outright)		
Purchase price	7 years' income	5.5 years' income
Subsidy	approx. 5% of total cost (= 6 months' income)	- (subsidies for house purchase abolished)
Financial assets		
Support	Employee savings bonus	(abolished)
	House building subsidy	(abolished)
Private pension (Riester assets)		
Basic conditions	- (not necessary)	Deferred taxation max. 4% p.a. from gross income
Regulatory pension (GRV)		
Gross pension level	48.3%	33.5%
Incapacity insurance	Included in GRV	Private
Own contributions to KV/PV in old age	-	Up to 5% of pension

KV/PV = health/care Insurance

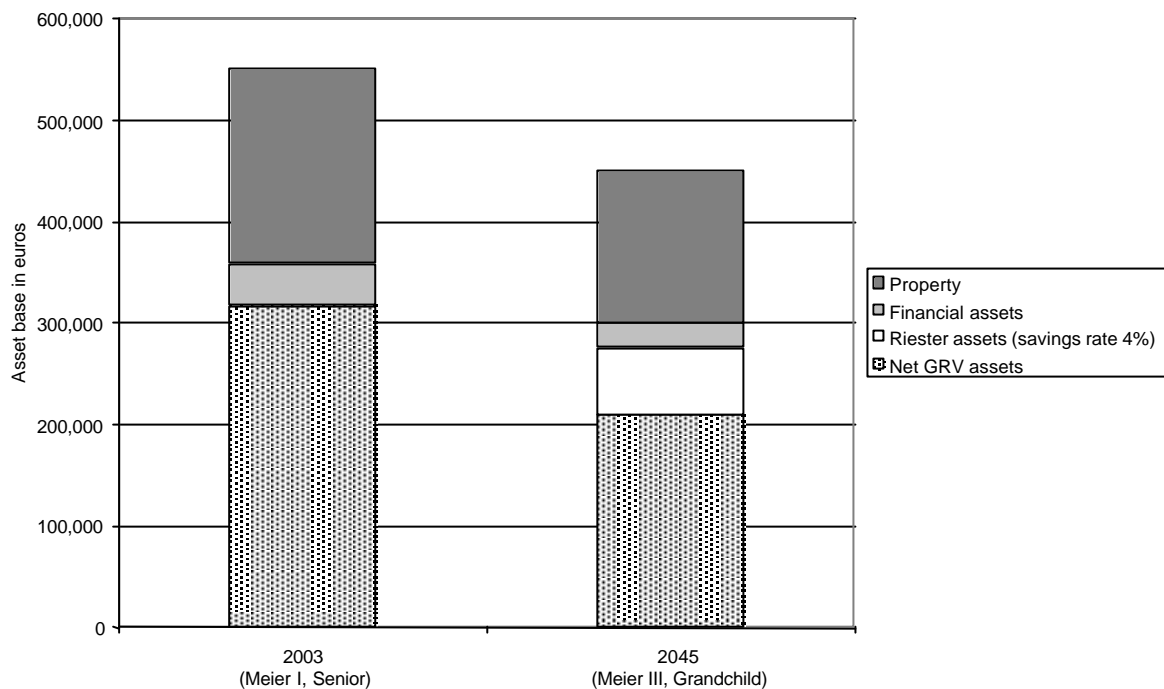
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Government policy will affect all aspects of the ‘Economics of Life’. Table 4 shows the various basic conditions faced by different generations of households as they build an asset base. In this, we assume that the generation of grandchildren can no longer count on the generous 'classical' support for the creation of an asset base that existed in the past. The comparison between Meier I and Meier III shows

how things must be restructured. The resulting fault lines in terms of the asset base on the eve of retirement are shown in Diagram 1.

Diagram 1: Asset base on the eve of retirement – today and in 2045

Selection criteria: household of a skilled worker, 60-year-old head of household, owner of his own home in the pre-reunification federal territory, two-person household, household formerly included two children, net monthly household income 2,000 euros/month, all figures adjusted for inflation.



Assumptions: property values and financial assets in 2003 are based on EVS (Income and Consumption Survey) 1998. The gross pension level has fallen to 33.5% by 2045¹; the grandchild's property was purchased for 5.5 rather than 7 times annual income; apart from subsidised pension contributions, less money has been put into savings² (see Table 2 for further assumptions).

GRV = state pension scheme (Gesetzliche Rentenversicherung)

Riester assets = subsidized retirement savings accounts

Source: our own calculations and EVS 1998

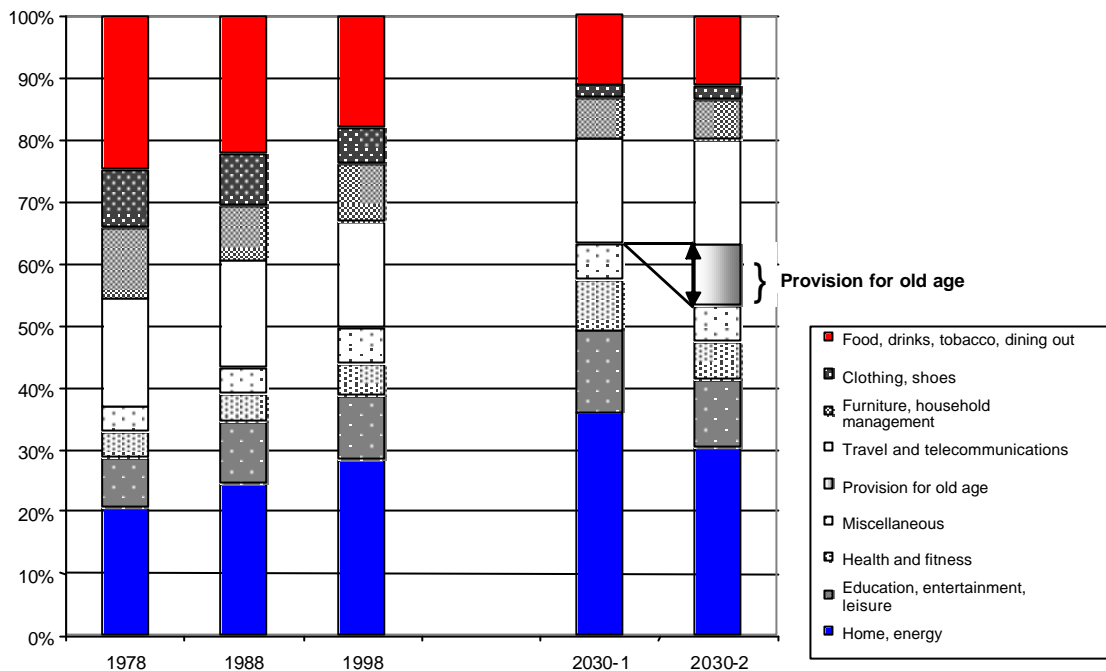
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The trigger for changes in behaviour over two generations comes about as a result of a drastic reduction in income in old age resulting from reduced rights through the statutory pension. Compared with the current situation, pension system rights will be significantly lower. The Riester savings as currently recommended, even if exploited to the fullest extent that is currently permitted from gross earnings, will in all likelihood not balance this out. On top of that, the value of any remaining financial assets and of one's own home will probably turn out to be less than their value today.

¹ cf. Schnabel (2003).

² Due to the disappearance of the 'classical' basis for building an asset base (2/3 reduction in the value of financial assets compared with the grandparents' generation) and on account of the supplementary burden arising from the Riester savings (2/3 reduction in cash-in values of insurance policies compared with the grandparents' generation).

**Diagram 2: Structures of private consumption of households under 65 years old
1978 to 1998 and projection for 2030**



Assumptions: in the 2030-1 scenario, a halving of the trends is assumed. In addition, the figures are based on a model which assumes that every ten years will see reductions in the proportions spent of 2.2% for “Food, drink and tobacco”, 1.2% for “Clothing and shoes”, one percent for “Furniture and household”, and an increase in the proportions spent of 2.5% for “Home, energy”, one percent for “Health and fitness” and one percent for “Education, entertainment and leisure”. In the 2030-2 scenario, the private provisions reduce the available budget by 10%. This is compensated for in that the growth in budget allocations for Home, Leisure and Health is reduced by three-quarters, all other categories remaining as in 2030-1.

Source: our own calculations from EVS

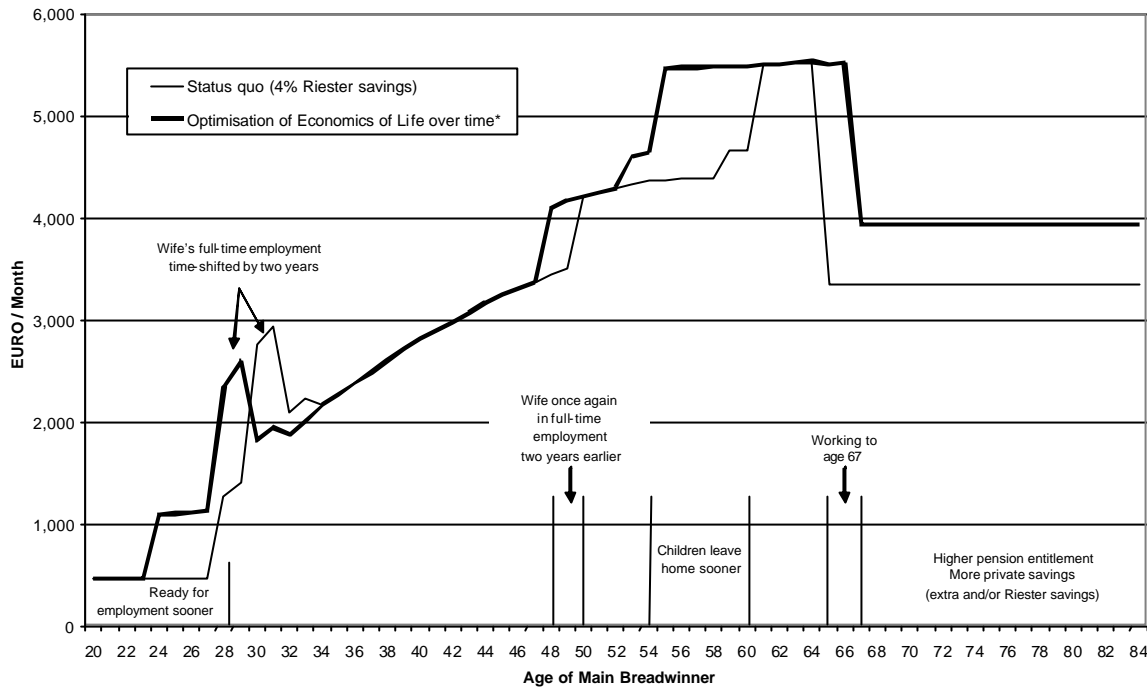
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As a consequence of the inescapable need for a rise in saving rates by those in employment, long-term trends in respect of changes in the patterns of expenditure by private households will have to develop (cf. Diagram 2). It is not possible to predict those areas in which private households will achieve the savings. In any case, government incentives will have an influence on the way in which savings are achieved. We anticipate that the traditional support for saving will dry up, that houses will become more affordable, and that there will be better opportunities for saving for the future out of gross income.

An important element of the ‘Economics of Life’ arises from the way in which time is put to use. Diagram 3 shows the differences in the way in which the capacity for consumption develops for a graduate household based on the assumption that in the future, careers will begin earlier, retirement will begin later and families will be started sooner, compared with a “traditional” family and career pattern.

Diagram 3: Improved Potential for Consumption through an Optimisation of the ‘Economics of Life’ for a Household living in Rented Accommodation

Definition: Potential for Consumption = household net income minus living expenses and the costs of child-rearing



*Starting a family two years earlier, career start four years earlier, enter retirement two years later.

Parameters: graduate couple with two children (begin careers at age 28, get married at 30, have children at ages 32 and 34, retire at 65, partner works full-time but part-time for as long as children under 16 are still living at home, death occurs on 85th birthday, no supplementary savings). Start work in the year 2010 with initial gross salary of 3,000 euros per month, start drawing pension in 2047.

Riester saving = subsidized retirement saving

Source: our own calculations

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A shorter education and later retirement enable much higher life-long consumption and above all a higher consumption in old age through acceptable savings rates. Alternatively, the necessary level of savings needed for old age in the light of a less efficient use of one's life could be reduced by a half. Even getting up earlier is worthwhile in the ‘Economics of Life’.

With a methodical approach, it is possible to compare various adaptations in that in each case one computes the equivalent value as a percentage of Riester savings. Thus, for example, the combination of measures required for a better utilisation of graduates' lives, which consists of a shorter education and starting a family earlier, would be just as effective as a Riester savings rate of around one percent for the whole of the time spent in employment. Furthermore, if when they stop (earlier), 25% of the former child-rearing costs are saved (extra savings), then this would already yield the equivalent of around two percent of Riester savings.

Table 3: Rules of Thumb for the ‘Economics of Life’

Lengthening the time in employment by...	...is equivalent to a life-long Riester savings rate of...
...retiring two years later	1% to 1.5%
...starting work four years earlier (graduates)*	c. 1%
Both together	c. 2%
If, in addition, 25% of former child-rearing costs are saved as well as...	...then taken together, this is equivalent to a life-long Riester savings rate of...
...retiring two years later	c. 2%
...starting work four years earlier (graduates)*	c. 2%
Both together	c. 3%

Riester saving = subsidized retirement saving

Source: our own calculations

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Similarly, an extension of two years in the working lives of graduates is just as effective as a Riester savings rate of around one to one-and-a-half percent during the whole of the time spent in employment if that time finishes at age 65. Together with the extra savings which represent 25% of the former child-rearing costs, a shorter time in education, and starting a family earlier, the changed ‘Economics of Life’ would even permit a reduction in the Riester savings rate of three percent. However, since a Riester savings rate of almost 7 percent would be required for our sample household, a savings rate at the currently recommended level of 4% should still be aimed for.