Pension reforms in Germany

"Poland and Germany: two approaches to reforming the pension system"
29th October 2010, Warsaw
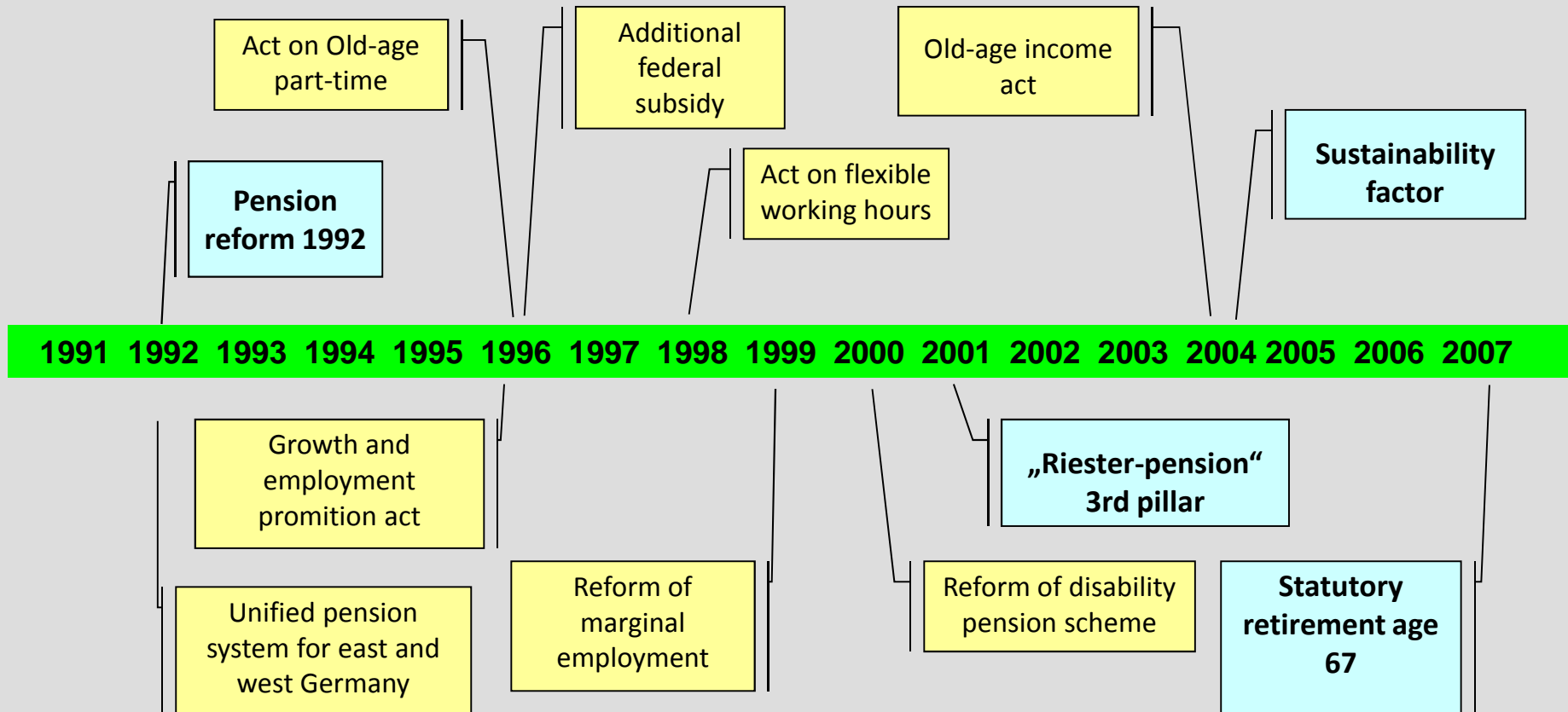
Johannes Geyer (DIW Berlin)

The German Public Pension System

o Earnings related PAYG-system for employees. Strong link between earnings (contributions) and benefits.

o Coverage: dependent employees (85%), exceptions for self-employed, marginally employed and civil servants

o Current pensioners: more than 90% receive benefits from the pension insurance

o Most important source of income in retirement: 2/3 of household income (old-age, disability and survivors pensions)

Challenges

o Demographic ageing threatens the financial sustainability of the system

o A low fertility rate (1.4)

o Increasing life-expectancy

o Baby-boomer generation reaching retirement

o Old age dependency ratio will double until 2040 (25% - >50%)

o In addition: high unemployment rates over decades; a growing low wage sector; increase in self-employment and marginal employment

o Since 1992 constant reform process: increase in contribution rates and transfers; reduced generosity of the system; increase retirement age; 3rd pillar pensions will become a necessary part of old-age income

Reform process since 1992

Act on Old-age part-time

Additional federal subsidy

Old-age income act

Pension reform 1992

Act on flexible working hours

Sustainability factor

1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007

Growth and employment promition act

„Riester-pension" 3rd pillar

Unified pension system for east and west Germany

Reform of marginal employment

Reform of disability pension scheme

Statutory retirement age 67

Since 1992: decreasing generosity of the pension system (Exception: benefits for Families)

Since 2001: increasing importance of 2./3. pillar pensions

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Old-age pension benefits

$$P_{t,i} = \left(\sum_{j=1}^{J} EP_{i,j} \right) \times PT \times AF_i \times PV_t$$

- Pension benefits are calculated as the product of four factors:

    1. EP - the sum of „earnings points" that reflect the employee's relative earnings position over his/her working life

    2. PT - the type of pension; PT=1 if old-age pension

    3. AF - Adjustment factor for early retirement (0.3% per month, max. 18% = 5 years) **[introduced 1992]**

    4. PV - current pension value (2010: 27,20 € West Germany); this index values the accrued earnings points and is adjusted annually. Pension indexation follows gross wage growth but is reduced by the „sustainability factor"**[introduced 2004]**.

Old-age pension benefits

$$P_{\text{2010,Standard Pensioner}} = 45 \times 1 \times 1 \times 27,2 = 1224$$

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Pension growth - indexation

$$PV_t = PV_{t-1} \times \frac{GE_{t-1}}{GE_{t-2}} \times \frac{100 - RP_{t-1} - CR_{t-1}}{100 - \underbrace{RP_{t-2}}_{\text{"Riester"}} - CR_{t-2}} \times \left(\underbrace{\left(1 - \frac{OD_{t-1}}{OD_{t-2}}\right)}_{\text{"Sustainability factor"}} \times \alpha + 1 \right)$$

- The pension value follows gross wage (net of contributions CR) growth (GE)

- and is adjusted by the contribution to the private pension scheme (RP „Riester Pension", 2001)

- and the sustainability factor which accounts for the development of contributers and pension recipients (OD, 2004)

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	2010	2020	2030	2040	2050
% increase of wages compared to 2002	4,6	21,4	43,7	70,0	101,3
% increase of pensions compared to 2002	2,9	15,7	27,9	48,0	73,4

Statutory retirement age

- Since 1992: in addition to deductions for early retirment, early retirement windows have been closed.

- 2007: increase of retirement age to 67 starting in 2012 until 2029

- After 2011, four retirement options remain. Early retirment is possible for health reasons (disability benefits , pension for handicapped (60...62/63...65)) and for long-careers (63/65)

Fiscal sustainability of the pension system

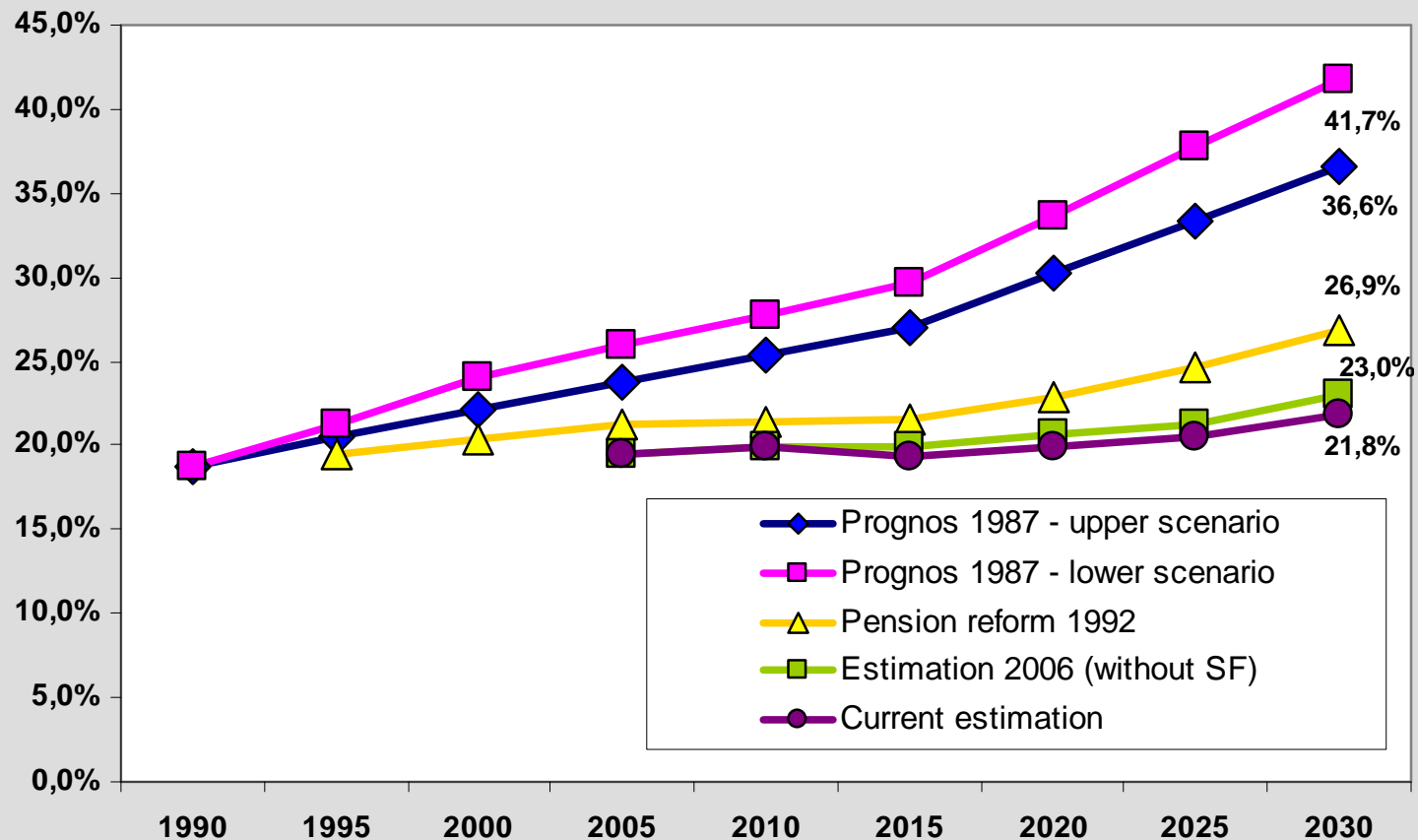**Gross public pension expenditures as a share of GDP between 2004 and 2050.**

	2004	2010	2015	2020	2025	2030	2040	2050	Change 2004-2050(2)
Germany	11.4	10.5	10.5	11.0	11.6	12.3	12.8	13.1	1.7
EU15(1)	10.6	10.4	10.5	10.8	11.4	12.1	12.9	12.9	2.3
EU25(1)	10.6	10.3	10.4	10.7	11.3	11.9	12.8	12.8	2.2

Source: EC, 2006, Table 3.3, page 71.

(1)   Excluding Greece.

(2)   Percentage points GDP.

Impact of reforms

Reduced growth of the contribution rate: already in 2007 5%-points lower than projected in 1987 – that is equivalent to 40-45 billion Euros per year.

Outlook

- Long-term financial sustainability achieved?
- Long-term reforms provide incentives to deviate from reform paths - political opportunism, for example:
  - „pension guarantee" in 2010
  - intermit reduction by private pension contribution rate in 2008 and 2009
- 1st pillar pension will lose significance
- Risks exist also in health and long-term care insurance
- Old-age poverty is currently low but is expected to rise in the future