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OLD-AGE PROVISION IN GERMANY: THE CRISIS IMPEDES A SHIFT TOWARDS HIGHER PRE-FUNDING

MARTIN WERDING¹

Following the deep recession that started in 2008, the German real economy has recovered rather quickly, implying that the crisis had next to no lasting effects for the unfunded German public pension scheme. However, continuing turbulence in the financial sector is impeding a re-orientation of the overall system of old-age provision that is urgently needed as a response to large-scale demographic ageing. In a nutshell, these are the consequences of the crisis for old-age provision in Germany. The situation is thus less comfortable than it may seem at first sight.

Background: recent pension policy

Traditionally, public pensions were the dominant source of retirement income in Germany. In fact, up until the 1990s the Statutory Pension Scheme, a prototypical Bismarckian “social insurance” scheme (Pestieau 2006, Ch. 5; Werding 2007, 97–100), was meant to secure earlier living standards at old age for those with a full life-time work record. (Additional) private provision was mainly considered an issue for high earners and for the self-employed.² Occupational pensions often topped up the public pension entitlements of employees with high earnings and other privileged sub-groups of “core” employees.

Around the turn of the millennium, a major shift was initiated within this traditional three-pillar system.

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² High earnings are not fully covered in the public scheme due to an upper limit on covered wages. The self-employed are generally not covered, with special rules applying to craftsmen running small businesses and special schemes existing for many professions where self-employment is widespread.

After years of heated debates, all major political parties finally agreed that this had basically become inevitable, due to a process of demographic ageing which started later than, for example, in the United States, but will ultimately be one of the most pronounced processes in the developed world, comparable only to expected trends in Japan or Italy. For the public pension scheme, this led to a series of reforms enacted in 2001, 2004 and 2007 by which the level of benefits is now inversely linked to the “system dependency ratio”,³ while the statutory age limit for claiming full benefits is currently being increased from 65 to 67 years.⁴ The resulting reduction in benefit levels, which will take place over the next two to three decades (Werding 2014), clearly calls for a greater emphasis on additional provisions in the second or third pillar. A new programme for subsidizing private old-age provision and a few amendments to the legal rules for occupational pensions were also introduced between 2000 and 2007 as a result.

Public pensions: largely unaffected by the crisis

When the crisis spread in 2008 and quickly became the “Great Recession”, Germany was hit by a severe downturn in aggregate demand and production to a greater extent than most other developed economies. From 2008 to 2009, real GDP fell by no less than 5.6 percent (United States: 2.8 percent; Japan: 5.5 percent; United Kingdom: 4.3 percent; France: 2.9 percent (OECD 2015)), creating an enormous risk to employment, while wage growth practically ground to a halt.

The German Statutory Pension Scheme is purely financed on a pay-as-you-go basis, holding only minor reserves that can safeguard the system against business-cycle fluctuations of regular strength and duration. In the short run, pension finances are thus directly dependent on labour market performance – while they also

³ “System dependency” measures the number of pensioners (weighted by amounts of individual entitlements) divided by the number of individuals in covered employment. The relevant mechanism, called “sustainability factor”, has a direct, negative effect for the assessment of benefits at award and for up-ratings of benefits after award, and hence for the overall level of benefits provided by the scheme.

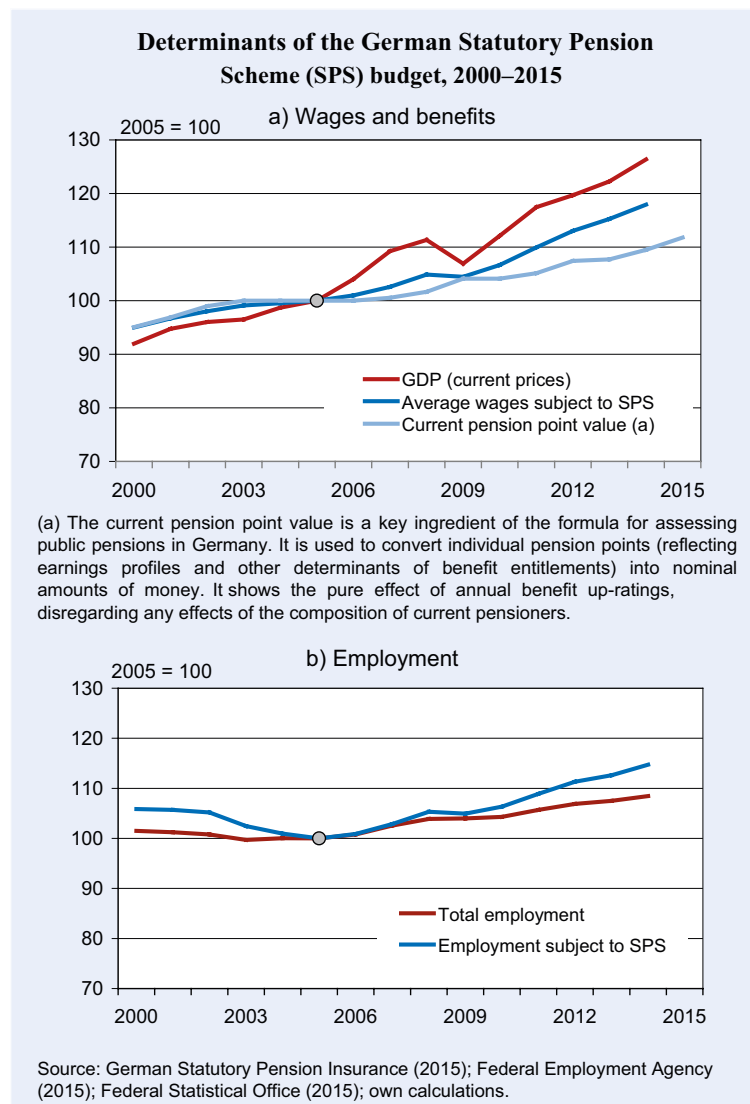
⁴ The increase started in 2012, for females and males alike, and is scheduled to last until 2029. If the actual retirement age goes up as well, this will slow down projected increases in system dependency and, therefore, moderate the expected decline in benefit levels.

depend heavily on demographic trends in the long run. Given the precise rules for operating the system and adjusting important parameters, the crisis could have triggered the following effects. On the one hand, lower employment and lower (growth of) wages reduce the tax base from which current pensions are financed, so that contribution rates have to be increased (once existing reserves are exhausted). On the other hand, lower wage growth and higher contribution rates reduce future pension benefits (due to a net-wage indexation component of annual benefit up-ratings), which takes away some of the pressure on pension finances; higher system dependency resulting from lower employment works in the same direction.

Further peculiarities of the German pension law that could be taken into account here relate to the fact that the system receives a substantial subsidy from the federal budget and to an amendment of the law governing benefit up-ratings which was made during the initial stage of the crisis. The subsidy is adjusted annually, partly in line with wages and partly in line with contribution rates, creating mixed effects of the same type as before. The *ad-hoc* amendment made sure that if the combined impact of all relevant factors might call for reductions in pension benefits, the latter would be held constant on nominal terms instead, with compensations through lower benefit up-ratings in subsequent years. The new rule was applied in 2010; *ex ante*, it was unclear whether the promise of compensations would be kept later on. But it turned out that this was actually the case and that the resulting increase in the benefit level was perfectly neutralised.

More generally speaking, whether all the effects described here turn out to be transitory or permanent, especially in the sense that the benefit level is permanently reduced, crucially depends on whether employment eventually recovers to its pre-crisis level and, more

Figure 1



importantly, whether wages ever return to their earlier growth path, following a recovery period with accelerated wage growth. Information that appears suited to answer this question is illustrated in Figure 1. A genuine counterfactual in which all consequences of the crisis are absent is, of course, missing. However, the data support the impression that all effects that directly matter for the pension budget were surprisingly small and basically only temporary in their nature.

To many observers, the performance of the German economy from 2009 onwards was truly astonishing. While the German labour market was generally considered to be particularly rigid at that time, the crisis revealed that multiple channels for “internal” flexibility of adjustments in labour utilisation had been developed in German firms during the very difficult times they had

gone through previously. These channels included flexible work-time arrangements (with enormous amounts of overtime accumulated in the years preceding the crisis), the recruitment of temporary workers (and earlier reluctance of regular hiring), plus a widely-accepted policy of wage moderation in collective bargaining and firm-level wage agreements. Together with the extensive use of instruments of labour market policy supporting a strategy of labour hoarding (“short-time work”) and some amount of good luck in a joint bet on a quick recovery of aggregate demand, this explains what was quickly termed the “German miracle” (Möller 2010; Burda and Hunt 2011).

Historically unique or accidental aspects aside, the German example illustrates potential strengths of a pay-as-you-go scheme in situations where labour markets and the real economy are functioning acceptably well and are able to absorb external shocks more easily than a financial sector in which major players, including supervisors and monetary authorities, have become nervous about possible systemic risks. The bad news for Germany is that success in this area is of limited value because unfunded pensions alone will never be sufficient to provide retirement income in the years ahead, i.e., when demographic ageing will become really pressing.

Moreover, what looks like a success can be misleading, or may even prove an illusion. While long-term prospects for financing public pensions continue to be difficult (Werdig 2014), the current, strong labour market performance has filled the reserves of the system up to their legal limit. Instead of reducing contribution rates, at least temporarily, as the law would demand, or simply accumulating higher reserves for the time period ahead, German politicians recently introduced additional types of benefit entitlements, which will still be effective when system dependency is likely to increase substantially, that is, between 2020 and 2035. Moderate increases in disability benefits, which form part of this package, can be justified as a protective measure for a group that is particularly vulnerable during the process of on-going adjustments. However, this claim does not apply to other, more expensive elements of the reform, such as privileged access to early retirement for workers with very long work records or increases in child-related benefit entitlements.⁵ The fruits of recent positive developments

⁵ To be sure, introducing or expanding child-related benefits in pay-as-you-go schemes is definitely defensible as a means of restoring incentives for bringing up children and investing in their human capital – which is basically a way of “pre-funding” for old age in these schemes (Cigno and Werdig 2007, Chs. 7–8). Here, however, increases were targeted at mothers of children born before 1992. Thus, there can be no incentive effects.

in the German public pension scheme have thus been spent on amendments that do not address actual challenges and partly contradict earlier reform trends.

Private provision: limits to voluntary diffusion

Reforms that were enacted to improve the long-term sustainability of the Statutory Pension Scheme are very likely to reduce the level of benefits deriving from the first pillar to below adequate levels. This reflects a fundamental trade-off in dealing with the consequences of ageing in pay-as-you-go pension schemes. Therefore, when taking their first steps to scaling back public pensions over time, German lawmakers also tried to strengthen forms of supplementary funded provision, as this constitutes the only alternative.

The original plan was to establish a mandatory system of private provision for all individuals covered in the Statutory Pension Scheme, scaled in such a way that private pensions would make up for the widening gap *vis-à-vis* the earlier benefit level of the public scheme.⁶ However, fearing public resistance politicians soon dropped the idea of using coercion and changed their strategy. The “Riester pensions” that were finally enacted – named after the responsible minister of that time – were voluntary, but publicly subsidised, directly as well as through special tax incentives, in order to induce people to choose appropriate amounts of supplementary provision.

“Certified” products falling under this programme have to meet a number of conditions (mainly, a guarantee of nominal amounts of contributions plus subsidies, no withdrawals before entering retirement, annuitisation of accumulated wealth). Following a short phase-in, expected contributions are now four percent of individual earnings covered in the public pension scheme. Subsidies are fixed, with a strong child-related component, so that subsidisation is much more pronounced for participants with low earnings or with several children. All active members of the Statutory Pension Scheme, plus their spouses, are eligible for receiving subsidies; meanwhile, the same applies to civil servants and their spouses.

⁶ The target level was a combined net-replacement rate of 70 percent, as the Statutory Pension Scheme had openly pursued a policy of keeping benefits at this level from 1992 to 1999. Whether this is indeed enough to maintain earlier living standards is an open question (Dudel, Ott and Werdig 2013), but the target made sense in the context of this reform.

Over time, a number of changes have been made to make the programme more transparent, less costly and, ultimately, more attractive. Nevertheless, participation rose strongly only between 2004 and 2008, that is, with some delay and until the financial crisis arrived. Different statistics tell different stories about how many individuals in the target group have been reached (Figure 2). Figures regularly published by the Federal Ministry of Labour and Social Affairs basically reflect the accumulated number of new Riester contracts. Alternatively,

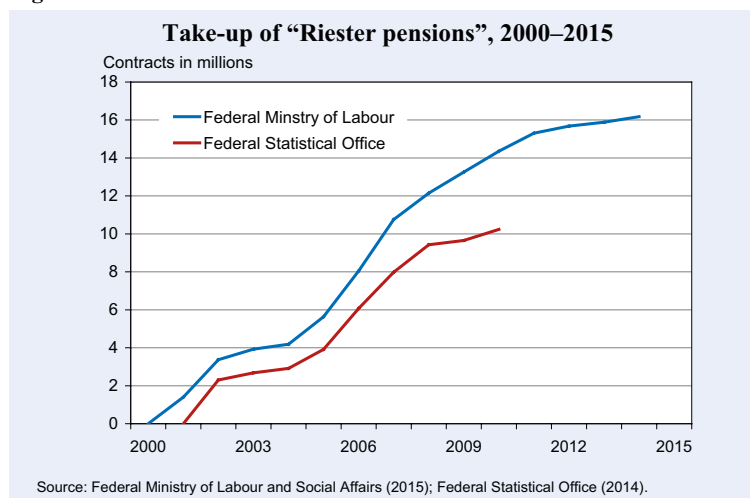
the Federal Statistical Office evaluates tax files that become available only with a massive delay to account for contracts that are actually used and subsidised. The difference between figures from both sources may thus either refer to individuals who made contracts but failed to claim subsidies, or to contracts that were temporarily suspended or are entirely out of use.

Another difficulty in assessing the success of the programme is that the overall size of the target group cannot easily be determined.⁷ Existing estimates put it in the range of 35 and 40 million people. Under the current framework actual take-up is thus between 25 and 40 percent, roughly ten years after the programme was implemented. Furthermore, the expansion has clearly slowed down towards the end of the observation periods, suggesting that it may eventually stop far away from the original goal of reaching full coverage. Another intriguing issue, namely whether subsidised contributions add to total provisions and aggregate savings, or whether they just substitute for other, less privileged forms of old-age provision or capital accumulation, has not been fully researched to date.

A number of studies have investigated the characteristics of those who are covered by Riester pensions (e.g., Bucher-Koenen 2011; Pfarr and Schneider 2013). They find, by and large, that participants have more children and a higher income than the average and tend to be financially literate. The first aspect is fully in line with current rules, while the other two could probably be addressed by further policy changes. Although their sub-

⁷ The reason is that major sub-groups – those who are eligible thanks to their employment status and those who are eligible through a marriage – may overlap, while relevant information cannot be recovered from existing employment statistics.

Figure 2



disation rates are rather high, many individuals with low earnings feel that they cannot save for old age simply because they are lacking resources. This perception may be true in some cases, and not in others. Participation among these individuals could certainly be increased by returning to a mandatory arrangement, while a line may need to be defined between those who actually can afford to make old-age provisions and others who would be exempted, most likely being in need of income support at old-age.⁸ Pension programmes aimed at the participation of a majority of the population should not require special financial expertise. To improve on this, one could make use of insights from “behavioural finance” and establish a mechanism for automatic enrolment, with an opt-out clause for those who are absolutely sure they need no additional cover.

However, a major obstacle to political moves in such directions are created by the recent, and currently on-going, financial crisis. Although actual losses of retirement savings appear to have been low (Börsch-Supan, Gasche and Ziegelmeyer 2010; Bucher-Koenen and Ziegelmeyer 2014), the crisis has undermined public trust in institutions and instruments that have never been very popular in Germany. In addition, low interest rates that are basically administered through unconventional monetary policies and may continue to apply for a while, at least in Europe, are far from helpful in this situation.⁹

⁸ In Germany, special benefits to protect against old-age poverty are offered outside the public pension scheme. A design feature that might be worth considering would be a reduction in transfer withdrawal rates for those with low benefit entitlements from other sources – just like with earned income in welfare schemes for individuals of working age – in order to preserve incentives to engage in provisions of all kinds for this group.

⁹ This scenario also entails considerable risk for the highly regulated business of an older type of private old-age provision through life insurance contracts, where providers have to keep promises that are not excessive, but are unrealistic under current conditions.

Most importantly, they obscure a fundamental advantage of funded old-age provision with respect to its long-run performance, based on higher annual yields and the effects of compound interest. Clearly, pointing to low yields as an excuse to refrain entirely from making old-age provisions and ending up with highly inadequate retirement income is not a good idea, but this is currently hard to explain. Heading for a broad-based coverage with supplementary funded pensions is therefore difficult in this environment, although it is definitely necessary.

Occupational pensions: a better vehicle?

While private old-age provision does not have a long tradition among average workers in Germany, occupational pensions have. It was already mentioned that, traditionally, they were used to top up public pensions of employees with high earnings (exceeding the upper limit of the Statutory Pension Scheme) and to stabilise “core” employment against fluctuations. Participation is thus biased against employment in small and medium-sized enterprises and against low-wage employees. Over the years, employers switched from DB to DC-type arrangements to avoid risks, and some closed old plans and did not introduce new ones to cut costs. Nevertheless, occupational pensions always remained an important instrument of supplementary old-age provision for a considerable share of workers.

In the period of reforms after the year 2000, two new channels were added to the relevant legal framework, one involving pure deferred compensation – as a right of employees, without any co-sponsoring from employers. Attempts were also made to integrate Riester pensions and employer-based plans, without much success in terms of take-up. Otherwise, employer-based provisions were outside the focus of recent pension policy. Longer time series of comparable figures are lacking. Reliable data up to the present only start in 2001, when occupational pensions covered 48.7 percent of all employees (TNS Infratest Sozialforschung 2015, 12). It can be assumed that this was a rather low figure, resulting from a long-term decline since the 1980s. Until 2009, coverage had increased again to 59.5 percent, due to the new instruments, but has remained at this level since then.

A question that German pension policy should seriously address is whether this relatively high level could not provide a good basis for further expansion towards a next-to-universal supplementary coverage that unfolds

as the ageing process continues, while public pensions must be scaled back accordingly. Two aspects deserve special interest in this context. One aspect is that German lawmakers to date have not extensively used options for influencing decisions taken by employers in a way that is politically desirable – e.g., by introducing auto-enrolment and an opt-out clause in this context (like in the UK) or by linking favourable tax treatment to target rates for participation among all employees or among specific sub-groups, such as low-earners (as with non-discrimination rules applied in the US).

The second aspect is that collective, industry-wide agreements could also provide a suitable vehicle for making considerable progress in terms of coverage. Arrangements of this kind could help to reduce costs, as they may produce solutions that are not one-size-fits-all, but sufficiently standardised to meet the typical needs of workers from the same branch of industry. More importantly, the key role of representatives of workers and their employers in negotiating plans and promoting participation could solve the problem of a lack of trust in financial intermediaries and financial markets, which is currently hindering the further expansion of supplementary, funded old-age provision in Germany.

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