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**Article**

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CESifo Forum

**Provided in Cooperation with:**

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

*Suggested Citation:* Werding, Martin (2022) : Is a Pension Reform Needed in Germany?, CESifo Forum, ISSN 2190-717X, ifo Institut - Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 23, Iss. 02, pp. 58-62

This Version is available at:

<https://hdl.handle.net/10419/263845>

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Martin Werding

# Is a Pension Reform Needed in Germany?

## ABSTRACT

Germany is being hit relatively hard by demographic aging. The latest round of major pension reforms dates back to the period from 2001 to 2007. The last government tried to prepare a new reform, but failed to reach a consensus. The new coalition government is not pursuing these plans any further. This article describes the changes in existing rules that the coalition is nevertheless considering and discusses actual reform needs.

According to the new German government's coalition agreement, the answer to the question raised in the title is, basically, no. While the preceding "Grand-Coalition" government had installed a commission that was meant – but eventually failed to – reach a consensus on a far-sighted pension reform, the new coalition formed by Social Democrats, Greens, and Liberal Democrats quickly declared that no major reforms of the mandatory public pension scheme will be considered during its term of legislation; that is, until 2025. Instead, the coalition has announced a few minor adjustments in this scheme, plus an examination of options for improving on participation in and the performance of occupational pensions as well as private old-age provision, which are both voluntary in Germany. The fact that, in a document with 177 pp., only one and a half pages focus on old-age provision has been a point of criticism about the new coalition agreement by a number of observers.

## REASONS FOR REFORMS



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The main reason why reforms of the German pay-as-you-go public pension scheme – and at least one of the other two pillars providing funded pensions – are needed is that the country will be hit relatively hard by demographic aging in the near future. Until 2035, Germany will be among the fastest aging countries in the world, a result of an after-war baby boom which came rather late and was small by international standards and a sub-

sequent decline in fertility which was substantially steeper and stronger than elsewhere. Between 1964 and 1975, the total fertility rate fell from 2.54 to 1.45 in West Germany and has roughly stayed constant at this level, with only a slight increase in recent years.<sup>1</sup>

As a consequence, the old-age dependency ratio is expected to double between 2000 and 2035 (Statistisches Bundesamt 2019). One-third of this increase has already materialized, while the remaining two-thirds are now imminent, as the German baby boomers are currently starting to enter retirement. After 2035, old-age dependency will not go down again, due to the long period with low fertility. Most likely, it will continue to increase at lower speed in the decades that follow (or stay constant at its elevated level at best), depending on future migration flows and further increases in life expectancy.

These unfavorable demographic trends have long been foreseeable. Thus far, German pension policy has responded to this perspective through several rounds of reforms, always with a time horizon of about 15 years (for an analysis of earlier steps, see Werding 2007). A major reform package was enacted in 1989, strengthening actuarial fairness in the public pension scheme and switching from annual benefit up-ratings aiming at a constant gross benefit level – which no longer made sense in times when contribution rates for pensions were projected to go up – to a constant net benefit level.<sup>2</sup> Between 2001 and 2007, a series of reforms followed which openly acknowledged that holding the benefit level constant, even on a net basis, would not be feasible against the pressure of demographic aging. Therefore, annual benefit up-ratings were inversely linked to changes in the system dependency ratio (besides existing links to wage growth and changes in pension contribution rates) as a self-stabilizing mechanism (Börsch-Supan 2007). To prevent the benefit level from declining too fast and to moderate the expected rise in contribution rates, a gradual increase in the statutory retirement

<sup>1</sup> Figures for East Germany were 2.51 in 1964 and 1.54 in 1975, respectively, indicating remarkably parallel trends at this time. Afterwards, annual fertility rates fluctuated much more in the East than in the West, before and after re-unification, but converged to a common level until 2005.

<sup>2</sup> Here, "benefit level" means a quasi-replacement rate, relating current pension benefits to current wages. Rules for benefit assessment and indexation imply that this level is the same for all workers with an equivalent work record, regardless of their age and duration of retirement. It is officially assessed based on a standardized pension derived from 45 years of contributions on average wages in each year. As the system does not entail much redistribution, the impact of shorter or longer work records and lower or higher wages on individual benefit entitlements is largely linear.

age from 65 to 67 was legislated, which has been effective since 2012 and will remain in place until 2031.<sup>3</sup> In addition, a new program for supplementary private provisions and their subsidization was introduced to make up for the projected decrease in the level of public pensions. Taken together, these measures were expected to render the system viable until around 2025. Therefore, initiating discussions on new reforms is now actually needed.

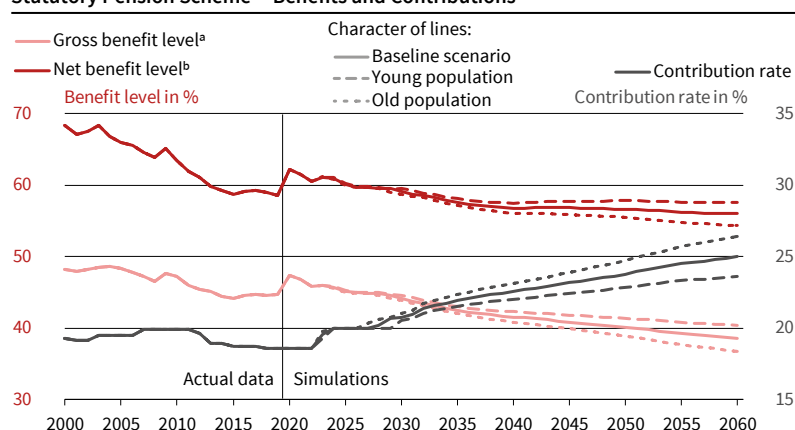
Figure 1 shows the outlook on how demographic aging will affect contribution rates and benefit levels<sup>4</sup> of the German public pension scheme until 2060 under the current legal framework.<sup>5</sup> In lieu of a richer set of sensitivity tests, the figure combines a “baseline scenario” with indications regarding the margins of uncertainty arising from alternative assumptions on future demographic trends (building on the medium variant and two extreme scenarios – called “young” and “old population” – of the latest official demographic projections prepared by the federal statistical office; Statistisches Bundesamt 2019).

### SHIFT IN POLITICAL DISCUSSIONS

The results presented in Figure 1 clearly demonstrate that the ongoing aging process is expected to put the German public pension scheme under pressure. Benefit levels which have gone up during the economic crisis triggered by the Covid-19 pandemic<sup>6</sup> will decrease considerably until 2035 and may continue to do so afterwards. Nevertheless, contribution rates for the public pension scheme tend to increase, starting from 2023, over the entire simulation period, even though the pension scheme regularly receives huge transfers from the federal budget that will also go up following existing rules for their annual adjustment.<sup>7</sup>

At the same time, the figure indicates that, against earlier expectations, contribution rates went down between 2010 and 2015 and have remained largely constant since then. This reflects a long period of strong labor-market performance which started in 2006, following a remarkable change in trend unemployment, and became fully visible during and after the Great Recession. The unforeseen recovery from

Figure 1  
Statutory Pension Scheme – Benefits and Contributions



<sup>a</sup> Pension benefits after 45 years with contributions on average wages as a percentage of average wages.

<sup>b</sup> Net of social insurance contributions and income taxes on pensions and wages.

Source: German Pension Insurance (until 2019); SIM.19 (from 2020 onwards).

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an earlier period of sluggish growth and continuously rising unemployment is certainly good news with respect to how Germany will be able to cope with its pronounced aging process. Without it, contribution rates for pensions would have started to increase a decade earlier than is currently projected and would reach even higher levels over time (see Werding 2007). However, while this new “German miracle” (Burda and Hunt 2011) unfolded, attention in political discussions about the pension system shifted away from the impending aging process and its long-term consequences.

In recent years, public debates about the German pension scheme were mostly driven by concerns about the ongoing reduction in the benefit level, which has basically come about as scheduled through the reforms taken from 2001 to 2007. Starting from 2014, a number of amendments were made to the rules governing public pensions, partly undoing earlier reforms (see Werding 2016 and 2020). When installing the commission on a new round of pension reforms in 2018, the ruling Grand-Coalition government also defined a “stop line,” implying that the level of pension benefits should not fall below a certain limit (48 percent, based on the official definition mixing gross and net benefit levels; see footnote 4) until 2025. To put those actively insured as well as their employers at ease, another stop line was added prescribing that contribution rates should not exceed 20 percent during the same time span. Afterwards, a number of politicians soon started creating the impression that prolonging the stop line for the benefit level, with or without a second stop line for contribution rates, might be feasible.

### PENSIONS IN THE 2021 ELECTORAL CAMPAIGN

Before and during the 2021 electoral campaign, a number of experts’ groups and think tanks generated ideas on how to further adjust the German public

<sup>3</sup> By rules allowing to retire early (starting from age 63, with discounts from acquired benefit entitlements) or late (with top-ups), the individual retirement age is nevertheless flexible.

<sup>4</sup> Official measurement of the benefit level in Germany uses a mixed approach regarding gross and net figures. Pensions and wages are taken net of social insurance contributions, but income taxes are disregarded as they are strongly dependent on individual characteristics. Here, they are assessed assuming that pensions or wages are the only source of income (taking into account a full transition to deferred taxation of pensions until 2040, as currently scheduled).

<sup>5</sup> The simulations have been prepared using the Social Insurance Model, version 2019 (“SIM.19”; see Werding 2021) for a description of underlying assumption and modeling strategies employed).

<sup>6</sup> This is not only due to the fact that pension up-ratings always follow wage growth with a one-year time-lag, but also to special rules applying if wages covered in the pension scheme decline – as they did from 2019 to 2020.

<sup>7</sup> Currently, total transfers financed from general taxation (or, partly, from fiscal deficits) cover about 30 percent of expenditure of the public pension scheme. In the simulations presented here, this percentage will rise to 33 percent until 2060.

pension scheme and the overall system of old-age provision to the next stage of the aging process (see, e.g., Wissenschaftlicher Beirat beim BMF 2020; Wissenschaftlicher Beirat beim BMWi 2021). At the same time, politicians on all sides were extremely reluctant to address the topic of new pension reforms throughout their campaigns.

Instead, the Greens and even more so the Social Democrats mainly tried to assure voters that they would not lay hands on two issues which the public considered the highest attention – reductions in the level of pension benefits below the current stop line and further increases of the statutory retirement age after 2031 (when the ongoing increase comes to a halt). Only the Liberal Democrats openly advocated reforms with respect to both these difficult issues to create room for maneuver regarding an overhaul and an expansion of supplementary private old-age provision, largely modeled on the Swedish “premium pension” which had been established in 2001 in combination with a far-reaching reform of the traditional Swedish public pension scheme. With respect to supplementary private provisions, the Greens advocated a similar concept in their campaign, but did not make this an element of a comprehensive reform proposal.

In the election, the Social Democrats won the highest share in the popular vote. Given the age structure of the German electorate, their low-voiced, but clear position against pension reforms may have contributed to this outcome (as predicted by Sinn and Uebelmesser 2002). Soon after the election, it also became clear that entering a coalition with the Greens and the Liberal Democrats was the most appealing, if not the only option for forming a new government.<sup>8</sup>

### CURRENT PLANS FOR THE TIME UNTIL 2025

As previously mentioned, the coalition agreement of the new government basically rejects any major reforms of the German public pension scheme, mainly reflecting pre-election positions of the Social Democrats in this regard. Specifically, the agreement confirms that – in line with existing rules – contribution rates will not be raised above the current stop line during the government’s term of office. The wording is stronger regarding the benefit level. Here, the coalition partners state that they will secure it to remain permanently above its current stop line. In addition, they state that there will be no further increases in the statutory retirement age, without indicating a time frame for this promise.

Following these initial commitments, the agreement explains that the coalition wants to strengthen the pay-as-you-go pension scheme mainly through higher immigration and higher labor-force participa-

tion of women and elderly workers. The simulations provided in Figure 1 are already based on substantial amounts of immigration – in the baseline scenario as well as in the “young population” variant – and on the assumption that female labor-force participation and effective retirement ages will continue to grow. Additional changes in these directions could mitigate the unfavorable trends in benefit levels and contribution rates shown there. But with realistic variations in relevant assumptions, these trends will never disappear. The coalition has also announced a small correction of benefit up-ratings that will become effective in 2022 to partly undo the rise of the benefit level related to the Covid-19 crisis (yet without violating the existing stop line). This will shift all projected curves in Figure 1 downwards by a very small margin, but will not alter the overall picture. In addition, the agreement states that more generous rules for assessing disability pensions which were introduced in recent years for newly awarded benefits of this type will now also be applied to benefits already awarded earlier. This may lead to small and transitory increases in contribution rates projected for the years until 2040.

Besides these changes in current rules that are all minor in their nature, the coalition agreement also contains a new idea, the consequences of which have yet to be seen. In 2022, the new government will increase the reserves of the public pension scheme by an extra injection of EUR 10 bn. that are meant to be invested on global stock markets by an independent authority. The plan is to build up a permanent stock of reserves for partially prefunding the scheme in order to reduce contribution rates below actual cost rates starting from some point in time in the future. “Demographic buffer funds” of this kind exist in other countries as well, following the prototypical Social Security Trust Fund in the United States. However, they are usually financed from higher contribution rates, not from taxes. Also, to really make a difference they have to become rather large compared to current pension expenditure. In the case of Germany, EUR 10 bn. are the equivalent of pension expenditure for about ten days. Important questions that the coalition agreement does not answer are these: how will these funds be augmented from 2023 onwards – when the “debt break” in the German constitution and fiscal limits agreed upon at an EU level will again become fully effective – in terms of both the size and the source of additional injections? Starting from when will the fund be utilized for subsidizing current pensioners and contributors, does “permanent” mean that the fund will never be depleted?

Even if these questions are answered, the arrangement may lack the transparency and consistency of the Swedish model for partially prefunding pensions which the Liberal Democrats and the Greens had in mind before the election. Moving in this direction could be accomplished more easily by building on additional considerations included in the co-

<sup>8</sup> The Christian Democrats who had led four preceding governments since 2005 had come in with the second highest share in votes. With this result, there was no unanimity in the party about attempts at forming a three-party coalition – again with the Greens and the Liberal Democrats – which would have been legally feasible.

alition agreement regarding occupational pensions and private provisions. Here, the coalition wants to make sure that new types of occupational pension plans (with defined contributions and without any guarantees) admitted under the preceding government are now actually utilized. It also considers new regulations allowing for more profitable investment. For supplementary private provisions, establishing a publicly administered fund, with lower costs than in the private sector and subject to an opt-out clause, will be examined.

## ACTUAL REFORM NEEDS

Leaving the current legal framework for old-age provision unchanged and letting the aging process go its way until 2035 and beyond does not seem to be a good idea. This message is clearly conveyed by the simulations shown in Figure 1, even though they cannot be taken to be precise predictions of what would happen then. Taking this route would imply that recent political debates about public pensions being too low and/or contributions being too high are perpetuated over several decades. In addition, contribution rates that reach 25 percent (and, together with contributions raised for health care, long-term care, and unemployment insurance, may exceed 50 percent well before 2060) will exert pressure on wage costs and net wages, deter immigrants who are urgently needed to cope with a shrinking and aging population, and create enormous risks for employment and economic growth.

Per se, prolonging current stop lines for important parameters of the pension scheme will not offer a solution either. These limits may not become binding until 2025,<sup>9</sup> but would do so soon afterwards. Fixing both the benefit level and contribution rates at current stop lines would lead to growing deficits in the pension scheme's budget. Resulting annual shortfalls would amount to tens of billions of euros in the late 2020s and 2030s, to hundreds of billions of euros in the 2040s (at current prices). Filling these gaps through higher transfers from the federal budget would drive up their share in this budget from a current 25 percent to over 60 percent – or require correspondingly higher tax revenues for the federal government – in order to maintain expenditure on many other items. In other words, the financial burden would be shifted around, but not reduced, maybe with different distributional effects, but with similar consequences for employment and growth.

What needs to be discussed, therefore, are (i) options for reducing the expected growth in pay-as-you-go financed pension expenditure in an acceptable way in order to prevent contribution rates from continuously increasing; and (ii) options for limiting the resulting reductions in retirement incomes through

prefunded components, as there is no further alternative (Sinn 2000). Essentially, this corresponds to an updated strategy for the reform path entered in 2001 to 2007. At the same time, it might be a basis for defining new “stop lines” – for total old-age provisions on the one hand and for levels of total benefits on the other – that are consistent with each other and can be maintained over a longer time horizon.<sup>10</sup>

Regarding step (i), several approaches are conceivable. In the context of the ongoing aging process, a natural approach is to further increase the statutory retirement age (beyond age 67) after 2031. By appropriately linking the age threshold for each cohort to increases in life expectancy, another self-stabilizing mechanism can be designed (Börsch-Supan 2007) which could perfectly neutralize the impact of higher longevity on the pension scheme's budget. In Germany, however, changes in life expectancy only account for a smaller part of the aging process compared to the pronounced decline in fertility rates. Therefore, additional measures are needed to reduce projected increases in pension expenditure. For instance, one could strengthen the existing (inverse) link between benefit up-ratings and the system dependency ratio, with a proportional impact on the benefit level for all retirees. Alternatively, one could make the German public pension scheme more redistributive, for example by reducing the benefit level more strongly for pensions deriving from higher earnings than for low-earner pensions; or one could make individual benefit levels dependent on the duration of retirement by switching from wage-oriented up-ratings to price indexation of pensions after award (as one component of a potentially more complex indexation formula).<sup>11</sup>

With respect to step (ii), Sweden indeed provides an interesting example for how partial prefunding can be successfully established within a differentiated system of old-age provision. In this sense, the examination clause in the coalition agreement for a similar arrangement sounds more promising than the intention to build up a buffer fund within the public pension scheme. In any case, a new solution should be more binding, more transparent, and should offer higher returns (after transaction costs) than existing instruments. What also needs to be considered, then, is the interplay of measures taken for steps (i) and (ii) and the appropriate timing of reforms in both areas.

## CONCLUSION

Preparing far-reaching pension reforms takes time – to create a sense of urgency, to select appropriate concepts, and to establish consensus. In spite of the reforms already taken, Germany is now rather late in

<sup>9</sup> According to the simulations made for Figure 1, this is less certain with respect to contribution rates than it is for the benefit level.

<sup>10</sup> However, for workers approaching retirement who have not engaged in making supplementary provisions in 2001 or soon thereafter, this may no longer be feasible.

<sup>11</sup> These alternative approaches have been suggested by Wissenschaftlicher Beirat beim BMWi (2021).



fully addressing the dimension of its aging process. Nevertheless, it can be conceded that for the new government there is more time left for some of the reform elements discussed here than for others.

Expanding funded components is urgent, as funds first need to be accumulated, while a schedule for increasing the statutory retirement age until 2031 is already under way. However, employees and employers need time to adjust to a further extension, so that it should be legislated a few years in advance. Discussing changes affecting the future benefit level of public pensions is a delicate issue that also should not wait. Most importantly, all this ought to be considered simultaneously to find comprehensive and consistent solutions.

An important drawback of the new coalition agreement is that it might create the impression among workers and pensioners that no major pension reforms are needed to deal with the upcoming aging process. How will these groups of voters react if this difficult issue returns in the run-up to the next election? On the other hand, coalition agreements need not be final words. In 2024 at the latest, the contribution rate for the public pension scheme will jump up considerably, for the first time in many years. Perhaps, if this adjustment draws near, this will trigger discussions on how further increases can be avoided.

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