Pension reforms in Germany

“Poland and Germany: two approaches to reforming the pension system”
29th October 2010, Warsaw

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The German Public Pension System

- Earnings related PAYG-system for employees. Strong link between earnings (contributions) and benefits.
- Coverage: dependent employees (85%), exceptions for self-employed, marginally employed and civil servants
- Current pensioners: more than 90% receive benefits from the pension insurance
- Most important source of income in retirement: 2/3 of household income (old-age, disability and survivors pensions)
Challenges

- Demographic ageing threatens the financial sustainability of the system
- A low fertility rate (1.4)
- Increasing life-expectancy
- Baby-boomer generation reaching retirement
- Old age dependency ratio will double until 2040 (25% - >50%)
- In addition: high unemployment rates over decades; a growing low wage sector; increase in self-employment and marginal employment
- 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

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

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

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

\[ P_{2010, \text{Standard Pensioner}} = 45 \times 1 \times 1 \times 27.2 = 1224 \]

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Pension growth - indexation

\[ PV_t = PV_{t-1} \times \frac{GE_{t-1}}{GE_{t-2}} \times \frac{100 - RP_{t-1} - CR_{t-1}}{100 - RP_{t-2} - CR_{t-2}} \times \left( 1 - \frac{OD_{t-1}}{OD_{t-2}} \right) \times \alpha + 1 \]

- 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 contributors and pension recipients (OD, 2004)
Pension growth - indexation

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\]

<table>
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<th>2010</th>
<th>2020</th>
<th>2030</th>
<th>2040</th>
<th>2050</th>
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<tr>
<td>% increase of wages compared to 2002</td>
<td>4,6</td>
<td>21,4</td>
<td>43,7</td>
<td>70,0</td>
<td>101,3</td>
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<tr>
<td>% increase of pensions compared to 2002</td>
<td>2,9</td>
<td>15,7</td>
<td>27,9</td>
<td>48,0</td>
<td>73,4</td>
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Statutory retirement age

• Since 1992: in addition to deductions for early retirement, 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 retirement 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.**

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<tbody>
<tr>
<td>Germany</td>
<td>11.4</td>
<td>10.5</td>
<td>10.5</td>
<td>11.0</td>
<td>11.6</td>
<td>12.3</td>
<td>12.8</td>
<td>13.1</td>
<td>1.7</td>
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<tr>
<td>EU15(1)</td>
<td>10.6</td>
<td>10.4</td>
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<td>12.8</td>
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<td>2.2</td>
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</table>

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