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Reforming an Unsustainable Public Pension System: The German Case

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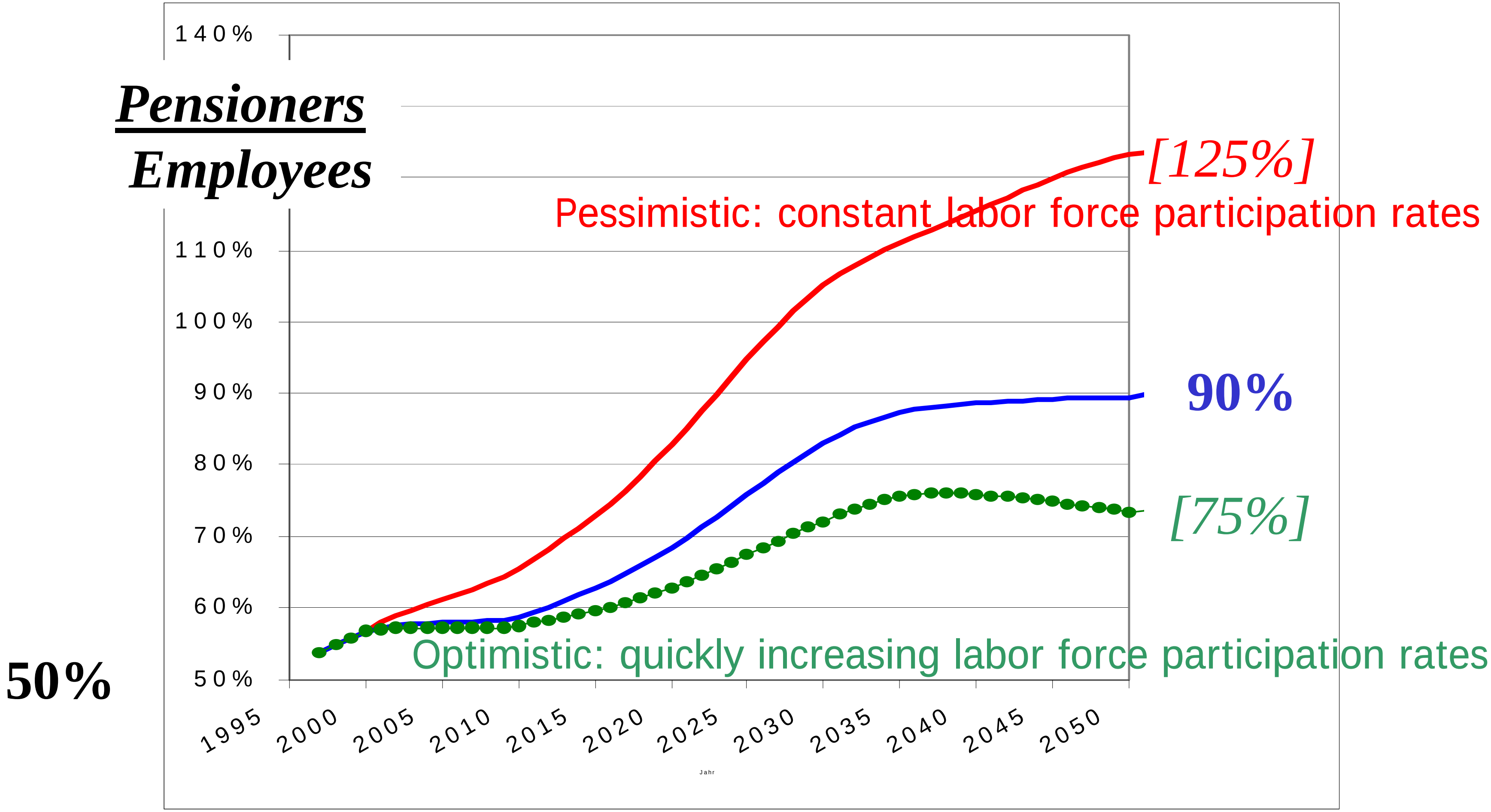
Ballooning System Dependency



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Cause 2: Baby Boom/Bust Transition

Schaubild 1.6

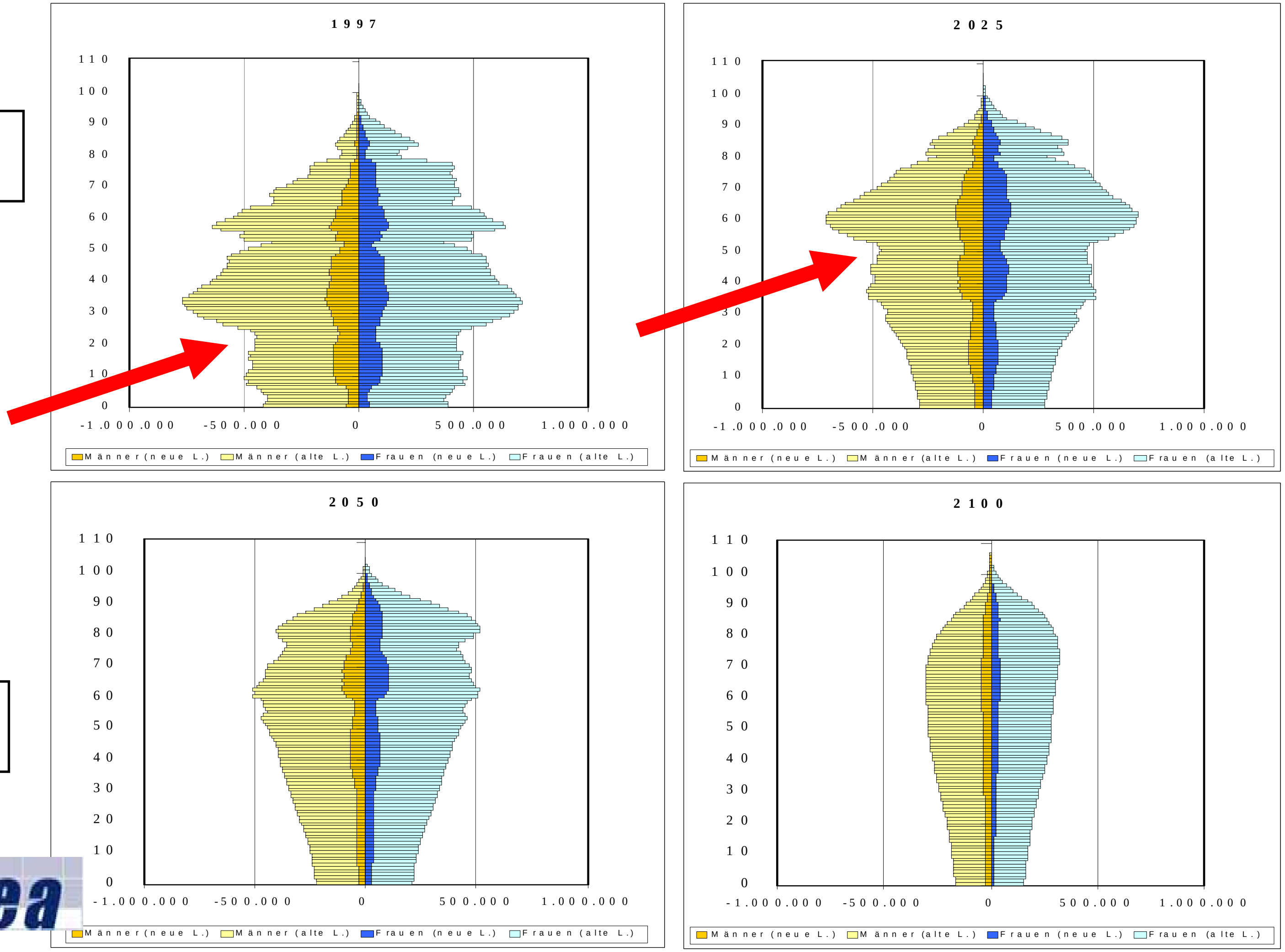
Entwicklung der Altersstruktur der Bevölkerung in den alten und neuen Bundesländern

2000

2025

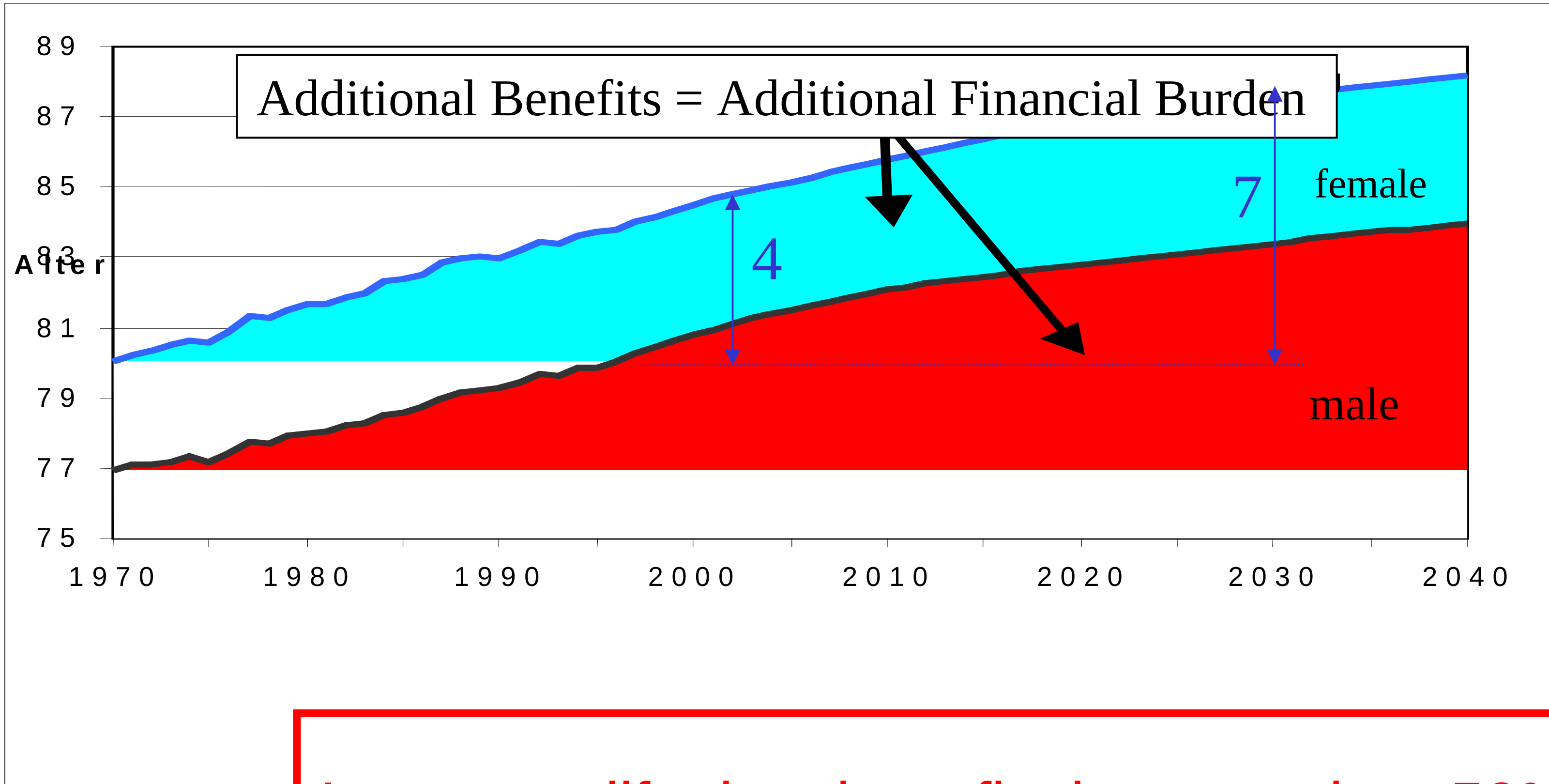
2050

2100



Birg/Flöthmann, IBS, Univ. Bielefeld 1999

Cause 1: Increasing Life Expectancy



Increases life time benefits by more than 50%!

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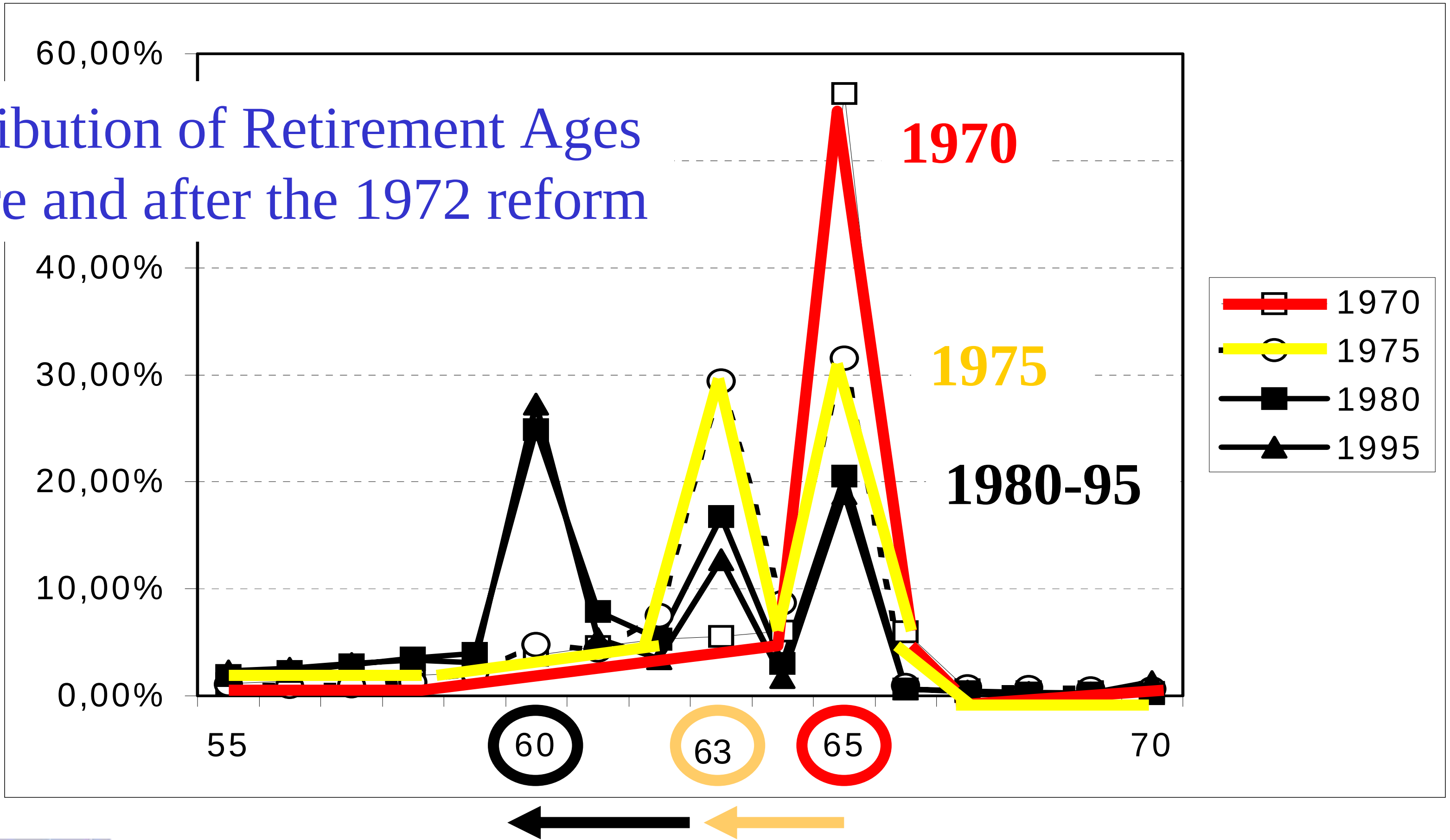
Cause 3: Costly Incentive Effects

Distribution of Retirement Ages
before and after the 1972 reform



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“Rational policy approach”:

Taylor cures strictly to causes and effects

Incentive effects: - Actuarial adjustments

Longevity: - Shift of retirement age

Babyboom / bust: - Cap contribution rates

- reduce benefits (Quasi-NDC)
- fill emerging pension gap (DC)

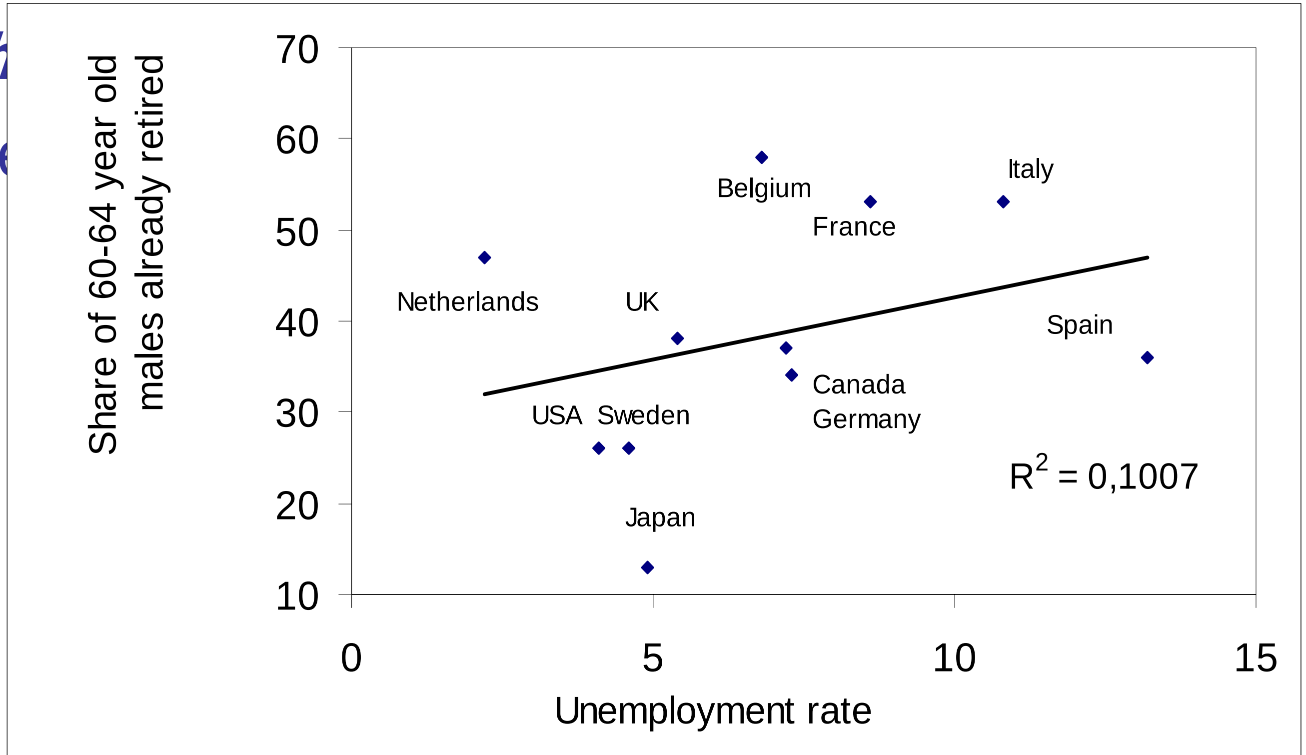
Longevity: Shift Normal (and Pivotal!) Retirement Age from 65 to 67

Very unpopular

⇒ late start (2011), slow phase-in (1 month p.a. until 2035)

Current high

⇒ cause and e



Babyboom / bust: Quasi-NDC

General idea of Quasi-NDC system with "sustainability factor":

Budget equation of a PAYG system:

cont_rate · wage · NWORK = repl_rate · wage · NPENS

Hold cont_rate = repl_rate · NPENS/NWORK **= constant!**

$\Rightarrow$ repl_rate has to be proportional to $\underbrace{\text{NWORK/NPENS}}_{\textbf{System dependency ratio}}$

Implementation in Germany

1. Point system for credits:

Benefit = Point_Value * Points * Actuarial_Adjustment

Points are accumulated over entire life cycle.
1 Point = 1 year of average earnings in that year

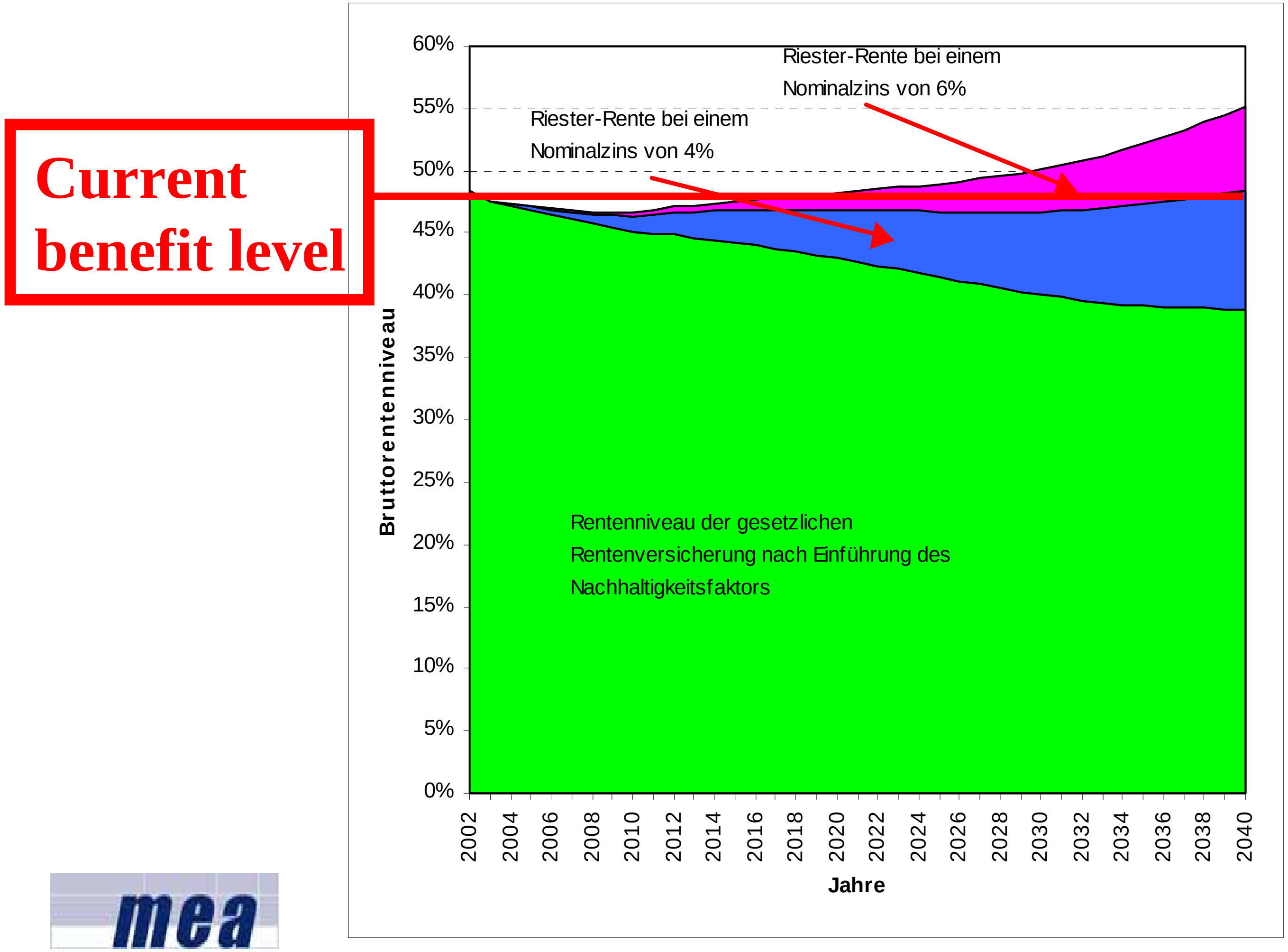
2. Value determined by wage growth and demography

Point_Value for each calendar year (not cohort!)
determined by ***wage growth*** net of contributions 2/3 1.5%
and ***change of system dependency ratio*** 1/3 -.3%

3. Actuarial adjustment

3.6% (plus 2.5% implicit) p.a. (about 2% too small)

Will the new pensions suffice?



Funded pillars
2 and/or 3 at a
4% saving rate
(return = 4% / 6%)

PAYG pillar 1
reduced by sustainability factor

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Lessons

- Due to **harsh demographics in Germany**: little maneuvering room
- Of course: retirement age, actuarial adjustments
- Need to cut pay-as-you-benefits also for pensioners
- Long-term transparent benefit reduction schedule
- Transition problems for 45-55 year olds
- Moderate rates of return suffice for young
- Need to maintain private pension contributions