Germany's pension system overhaul shifts burden to young workers, raising risks to fiscal sustainability

The agreement by Germany's government to guarantee pension levels until 2025 would lower fiscal flexibility and weight spending toward older workers and pensioners and away from younger people, endangering the country's economic growth potential.

The German coalition government approved a package of retirement reforms in August, including fixed replacement rates and contribution thresholds as well as higher entitlements for mothers and low-income based pensions. The measures reflect the government's willingness to increase social spending at a time of Germany (AAA/stable) recording strong economic growth.

As the proposal stands, the new pension guarantee is set to put an additional burden on Germany's public finances over the medium-term and represents an important shift in the redistribution of tax revenues from the Baby Boomer generation's children back to their parents, says Scope Ratings.

The agreement is a compromise within the governing coalition on the Social Democratic Party's original initiative, which was to maintain pension levels at 48% of final salaries by 2040, which, together with new entitlements for mothers and early retirees, requires the approval of parliament before coming into law.

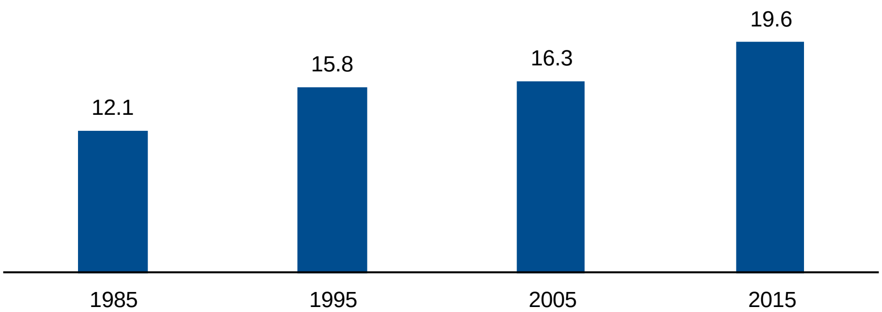
Scope believes the planned German pension changes cast light on the significance of two broader sustainability factors as investors consider environment, social, governance (ESG) risks when analysing public finances:

1. Demographics: The interplay between a country's old-age dependency ratio (a factor in Scope's quantitative model under its sovereign methodology), which indicates the share of the 65+ population dependent on the working-age population, and prudent government policy, vital in the funding of future pensions and healthcare costs;
2. Public debt sustainability: Governments have to frame social contracts between generations, balancing present demands and future contingent liabilities.

Widening gap between contributors and pensioners

Germany, like other advanced economies with pay-as-you-go pension systems, is facing a potential financing crunch. An increasing number of incoming retirees born between 1946 and 1964—the Baby Boomer generation—require pensions which have be financed by a diminishing number of working age people, demanding of the latter increased contributions or higher taxes. Scope projects that the gap between the demands of recipients and payments of contributors could widen over at least the next 20 years, on the grounds of longer remaining life expectancies of incoming retirees (see **Figure 1**).

Figure 1: Remaining life expectancy at year of pension entry



Source: German Pension Agency, data report of 2017

Analyst
Dr Bernhard Bartels
+49 69 6677389 19
b.bartels@scoperatings.com

Team Leader
Dr Giacomo Barisone
+49 69 6677389 22
g.barisone@scoperatings.com

Media
Matthew Curtin
+49 30 27891 147
m.curtin@scopegroup.com

Related Research

Scope confirms and publishes Germany's credit rating of AAA and changes Outlook to Stable – 30 June 2017

Public Finance Quarterly Update: Key Risks, Scope's Views and Rating Actions – 12 April 2018

Scope Ratings GmbH
Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Two-fold impact on public finances

Under these circumstances, the planned extended pension guarantee has direct and indirect consequences for the economy and public finances.

The immediate impact is on central government's payment into the pension system via a state grant, currently valued at EUR 91bn, amounting to 2.7% of GDP in 2017. Government projections show a further increase by EUR 40bn (equal to 1.2% of GDP) towards 2030, triggered by incoming retirees. The younger generation cannot replace losses to the system from those dropping out despite higher projected contribution rates, which results in a constantly rising gap between payments to recipients and those made by contributors.

Filling this gap in pension funding by raising extra taxes could, in theory, result in an overall neutral impact on Germany's fiscal balance. However, in practice, there is an indirect impact that may prove less benign considering the shift in state resources to older generations from younger ones.

First, older citizens are more likely to save additional income, which reduces economic growth and thereby squeezes fiscal revenues indirectly. Secondly, the pension guarantee applies to both low- and high-income pensioners, with the larger share accruing to high-income retirees based on the equivalence principle, entitling higher contributors to higher pensions. High-income retirees have a lower propensity to spend, meaning that shifts in state resources to this group further lowers economic activity and hence fiscal revenues.

Past benefits of the pay-as-you-go system

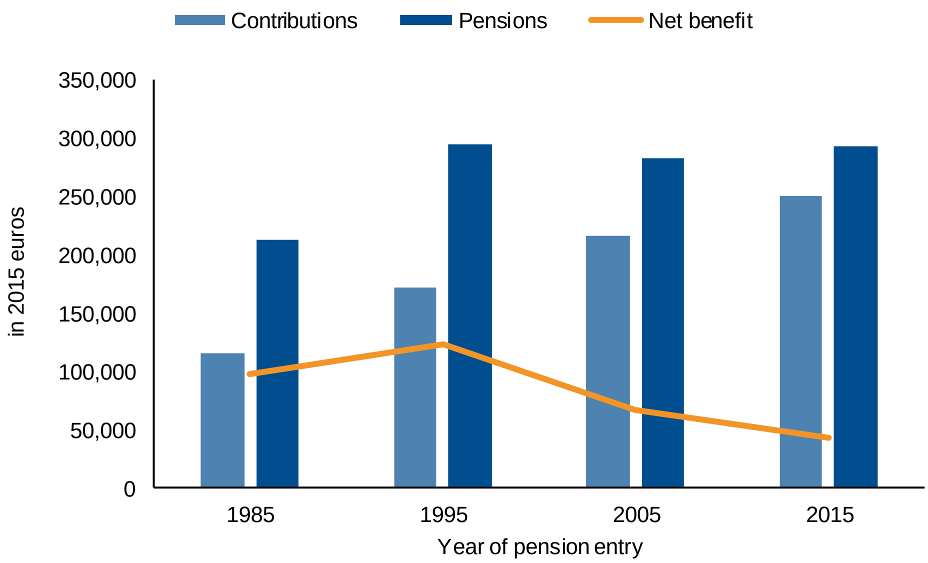
Major drivers of pension benefits

The German government could still address this problem. One way to adjust the so called intergenerational contract would be by resetting the retirement age or by changing eligibility criteria (by age of entry or for different groups, such as non-working mothers, early retirees, etc.). Also, the contribution rate (currently at 18.6% of gross monthly income) and the pension replacement rate (fixed at 48% of the salary) could be adjusted, as exemplified by compromises involved in the latest reforms. A change to any of these "adjusting screws" affects the intergenerational distribution between the young and old.

To illustrate the varying benefits across the generations from the pay-as-you-go system, Scope has calculated individual real benefits of salaried workers from the pension system across four retiree groups. Combined with projections for future benefits of today's young workers, the analysis exemplifies the increasing imbalances in the intergenerational distribution of income.

The net benefit for a pensioner from the state pension system depends on three factors: i) The size of contributions during working life, ii) the pension replacement rate, and iii) the remaining life expectancy after retirement. Scope has calculated the net real benefit for an individual from each of the four groups assuming a person worked 45 years, except the oldest, which belonged to the war-time generation (see **Figure 2**). The first individual retired in 1985, followed by the younger groups every ten years from there (1995, 2005, and 2015). The oldest generation contributed the least to the pension system based on relatively low contribution shares and wages compared to younger peers. The low in-payment is, however, balanced by the shortest remaining life expectancy on retirement of only 12 years. Yet, the oldest age group receives a net benefit of close to EUR 98,000 in 2015 prices thanks to a high replacement rate, equal to almost 60% of former salaries.

Figure 2: Life-time real net benefit of pensioner via the German pension system



Source: German Pension Agency, data report of 2017, calculations of Scope Ratings GmbH

Large benefits for older generations

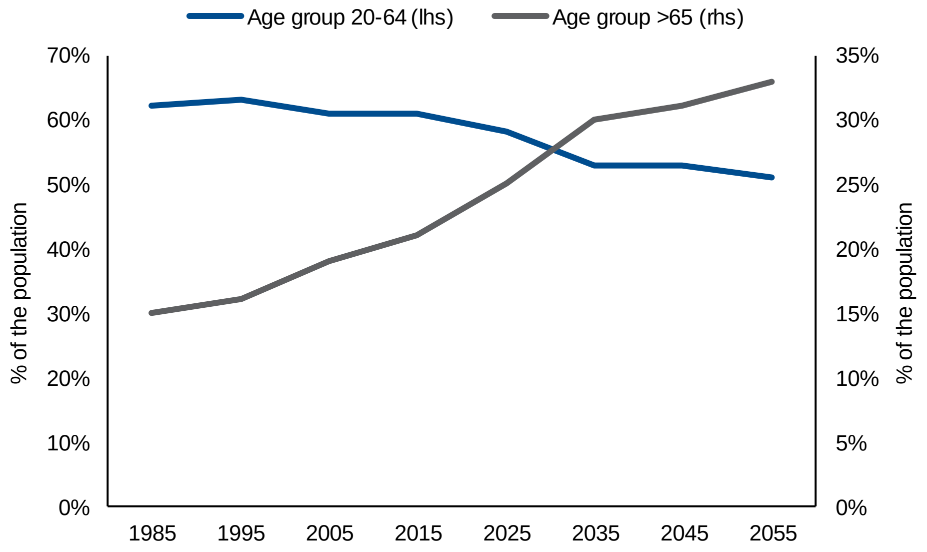
A person who retired 10 years later had a remaining life expectancy of 16 years on retirement and received a pension level equal to 54% of his/her previous salary. This worker paid in higher contributions than the 1985-retiree did and received a lower pension, which is still outweighed by the rapid increase in life expectancy, resulting in a real net benefit of EUR 123,000 (in 2015 prices). An additional driver of the high net benefits for the two oldest age groups is the legal requirement for an upward adjustment of pensions according to current wage growth to ensure equal living standards across generations.

Though the remaining life expectancy increases for the younger two retiree groups (those retiring in 2005 and 2015), their net benefits shrink considerably compared to their older peers. Both workers contribute higher shares of their salary during their working lives and receive lower replacement rates amounting to less than 50% of their previous salaries. Even so, these age groups receive an average net real benefit of EUR 50,000 from the pension system assuming future governments refrain from adjustments of the replacement rate.

Young workers face rising uncertainty

The situation changes for the children of the baby boomer generation. First, their contribution rates are supposed to increase from 18.6% to more than 22% within the next 10 years according to the government's most recent pension report. At the same time, the share of pensioners will increase by 10% together with an equivalent decline in the working age share (see **Figure 3**). In other words, new entrants, especially in high-skilled jobs, will not compensate for the outflow of ageing workers. This is an unprecedented situation in the pay-as-you-go system, which requires either additional contributions (by workers or the government) or lower entitlements in the next 20 years, assuming no major changes in life expectancies and net migration flows.

Figure 3: Projected ageing in Germany



Source: Population Statistics, Federal Statistical Office, Wiesbaden

In its latest pension report, the government has outlined its plans to finance the increasing gap between working-age population and pensioners. The calculation still includes a lower pension replacement rate of 45%, which is subject to discussion as the Social Democrats continue to advocate for an extension of the current guarantee until 2040.

Put differently, today's younger generation faces an additional burden over the next 20 years from higher taxes to finance the state grant. At the same time, the young experience a sustained stagnation in real incomes (compared to the high real wage growth experienced by their parents), contributing to increasing risks to economic growth potential, which may filter down to lower revenues from contributions and taxes.

The German system in comparison to industrialized peers

Various pension reforms in OECD countries

All industrialized economies are confronted with ageing societies, which require adjustments of their pension systems. However, reform efforts differ considerably across OECD economies. On average, the retirement age, entitling to full benefits, increases by 1.5 and 2.1 years on average for men and women based on higher average life expectancy. And yet, the old-age dependency ratio is projected to almost double over the next 35 years to an average of 53.2% being aged 65 years and over per 100 people of working age (20-64).

EU countries themselves are taking different approaches. The French government envisages pension reforms in 2019 focused on creating a more unified system with more equal entitlements for employees from the private and public sector and a higher retirement age, which currently stands at only 62. In contrast, the retirement age in Denmark, the Netherlands, and Italy is 68. Other countries have aligned replacement rates to higher remaining life expectancy, which automatically lowers pensions.

Low flexibility for German pensioners

The results of the 2017 OECD pension report show that Germany lacks the flexibility of other countries on when people can retire. Some such as Sweden or the UK provide incentives for older people to combine work and pensions (up to 17% of the 55-69-year-old), whereas Germany provides neither a bonus for those who want to work longer nor charges a sufficient penalty on early retirement[1]. This explains the relatively large share of early retirees (10-15%) compared to the OECD average (5-7%) and the small percentage of workers who postpone retirement beyond the official pension age.

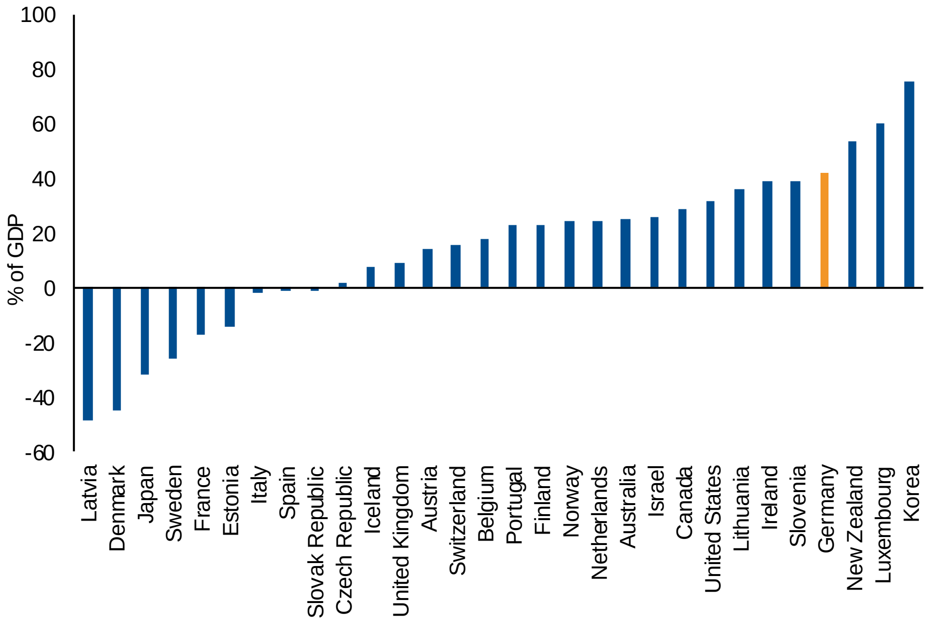
Pension liabilities put risk on medium-term outlook

Current economic strength delays fiscal pressure

Previous German governments have managed to bring down gross debt from more than 80% in 2011 to 64.1% of GDP in 2017, thanks to cyclical trends, investors' flight to safe haven and expenditure restraint. Against the positive trend, Scope expects that the unfavourable demographics will soon put pressure on public debt sustainability unless the government changes direction towards a better rebalancing of future pension liabilities for the baby-boomer generation. IMF calculations show that Germany needs to raise another 40% of GDP for pensions until 2050, placing them among the top 4 industrial countries with the highest future pension spending needs (see **Figure 4**).

Germany's AAA ratings are underpinned by its strong economic performance and a highly diversified and competitive economy. Unemployment has fallen to levels not seen since the reunification, despite the challenges from recent migration flows. Thus, Scope does not anticipate a substantial worsening of public finances in the short-term but expects the impact of increasing pension entitlements to become material over the next 10-15 years. This said, it remains unclear if these future liabilities will be financed by higher taxes, pension contributions or budget deficits.

Figure 4: Change of the net present value to future pension spending (2015-2050)



Source: IMF Fiscal Monitor, April 2018

[1] The only exception holds for people who voluntarily work longer and can now continue to pay-in contributions, which was not possible earlier.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer