

Reforming an unsustainable pension system: The proposals of the "Rürup Commission"

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1. Some brief background: Current state of system

- Main features of the German pension system
- Two dimensions of demographic change
- Undermining incentive effects
- Weak economic growth

2. Causes and cures

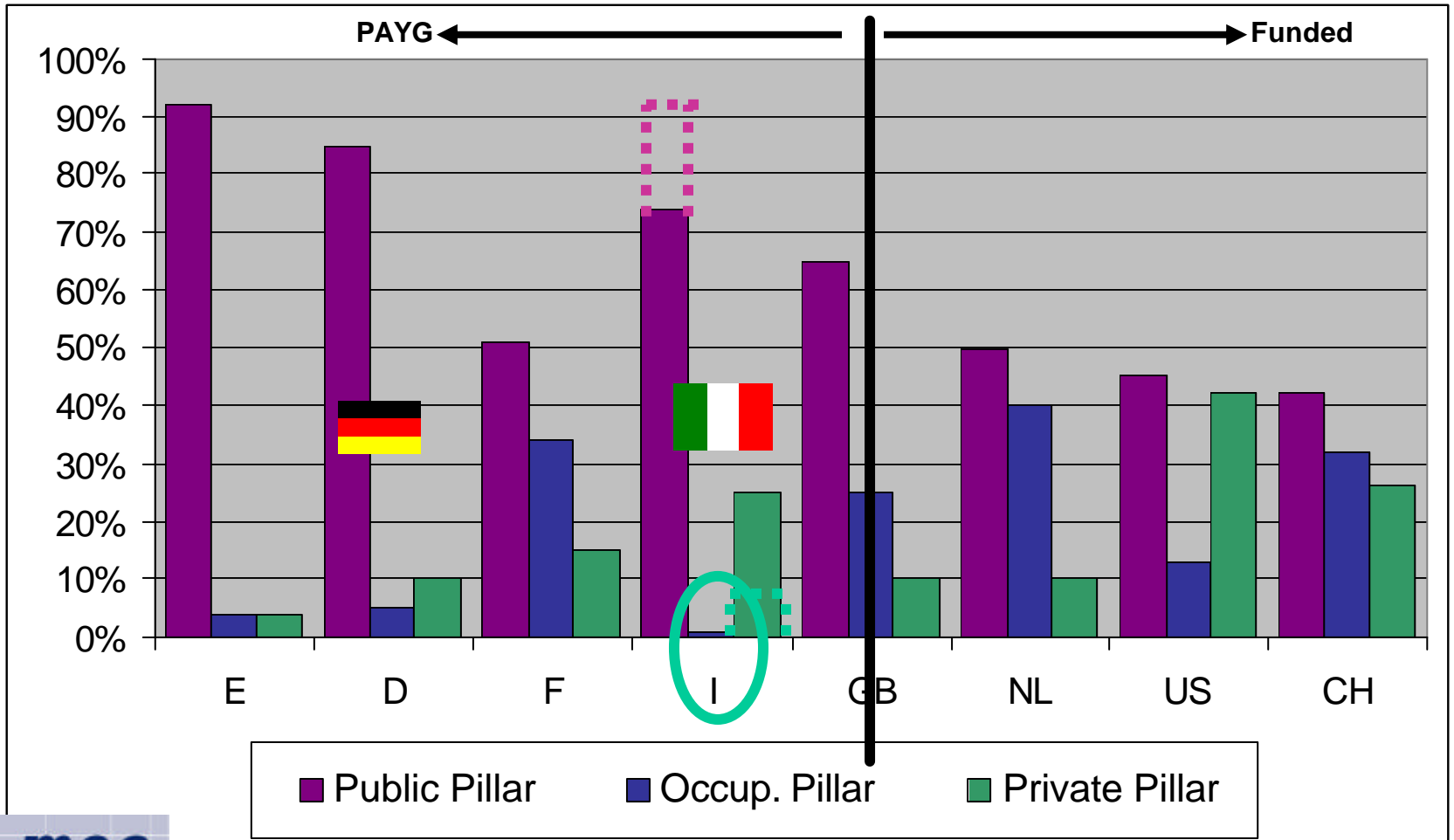
- Growth: Stabilize contribution rates
- Incentive effects: Actuarial adjustments
- Longevity: Shift of retirement age
- Babyboom/bust: „Sustainability factor“ and partial funding

3. The political economy of pension reform

- Short run vs. long-run options
- Possible „deals“ and trade-offs

1. Background

The German Pension System in a Nutshell



1. Background

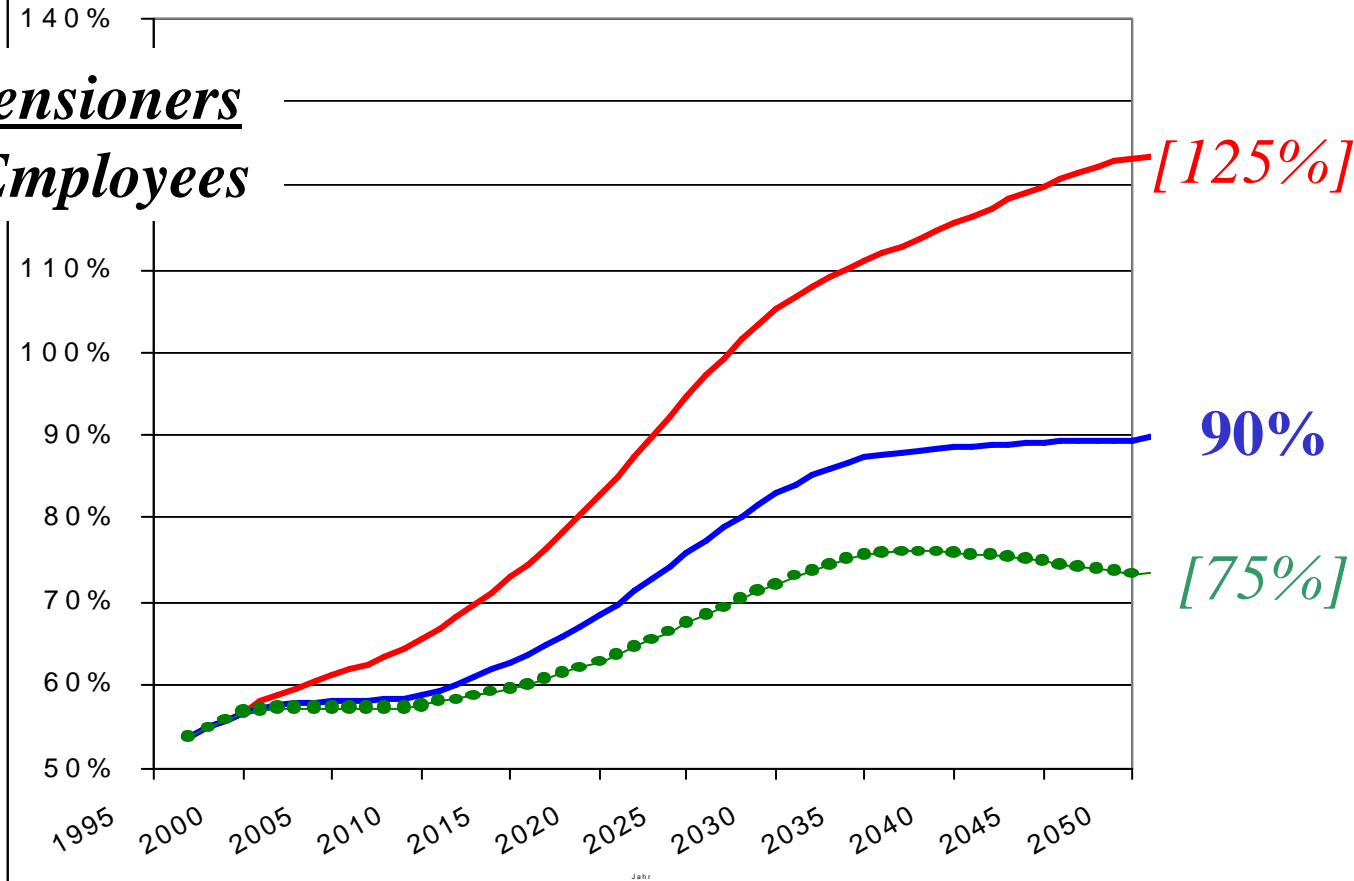
The German Pension System in a Nutshell

- **Public system: Mandatory, universal and generous**
- Coverage: 90-95% of workers; 80-85% of income
- Statutory replacement rate: $\approx 70\%$
- Benefits proportional to (1) life time earnings, (2) years of service, (3) net wages of current workers (double indexation)
- Early retirement at ages 60/63 without actuarial adjustment
- **...and costly:**
- Direct contributions: 19.5% of gross income (≤ 2.1 avg. earnings)
- Indirect contributions: $\approx 9\%$ (VAT, Eco/Petrol, other taxes)
- **...and there is little else:**
- Some occupational pensions (5%), some private savings (8%)

Ballooning System Dependency

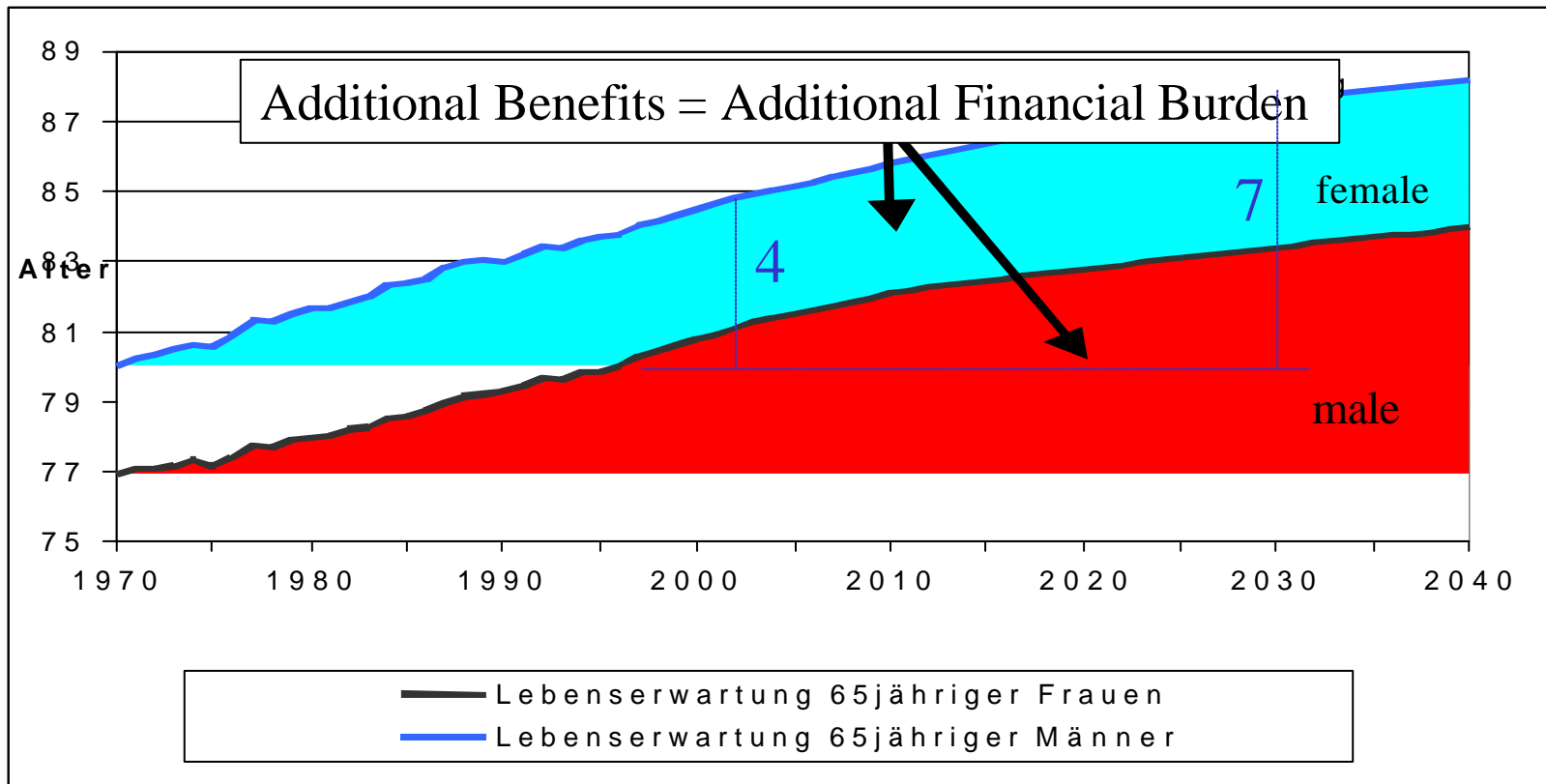
Pensioners

Employees



50%

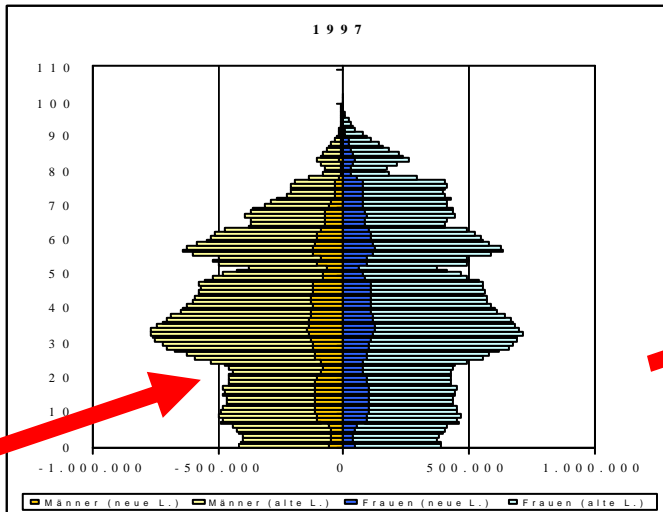
Increasing Life Expectancy



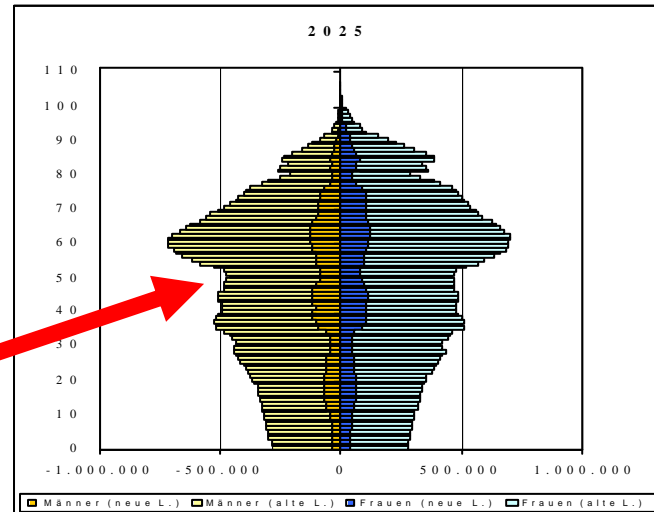
Baby Boom/Bust Transition

Schaubild 1.6
Entwicklung der Altersstruktur der Bevölkerung in den alten und neuen Bundesländern

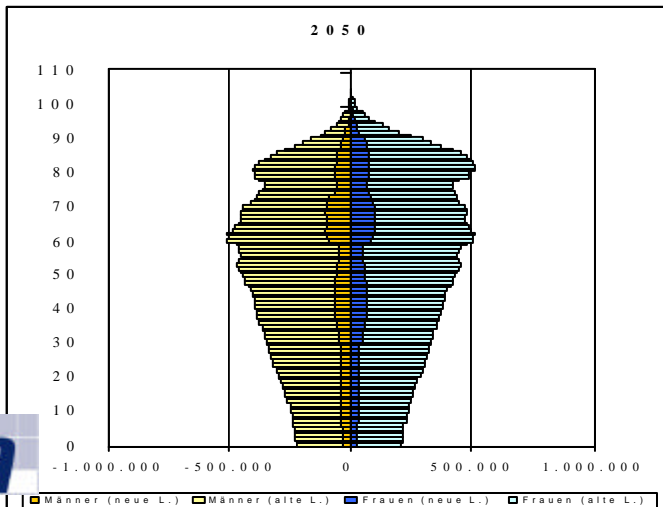
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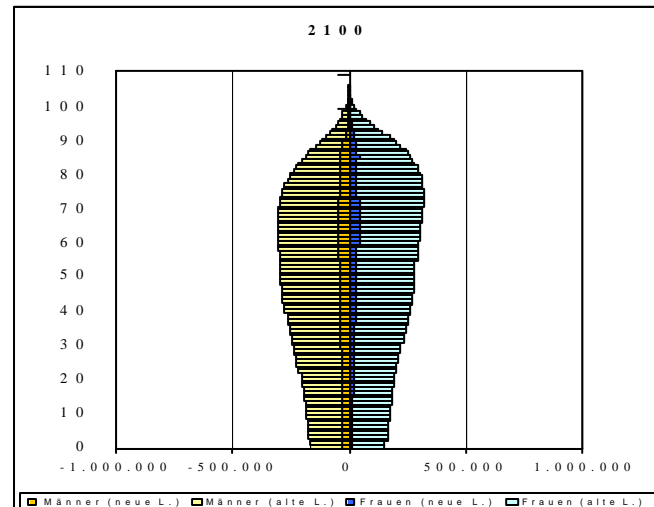
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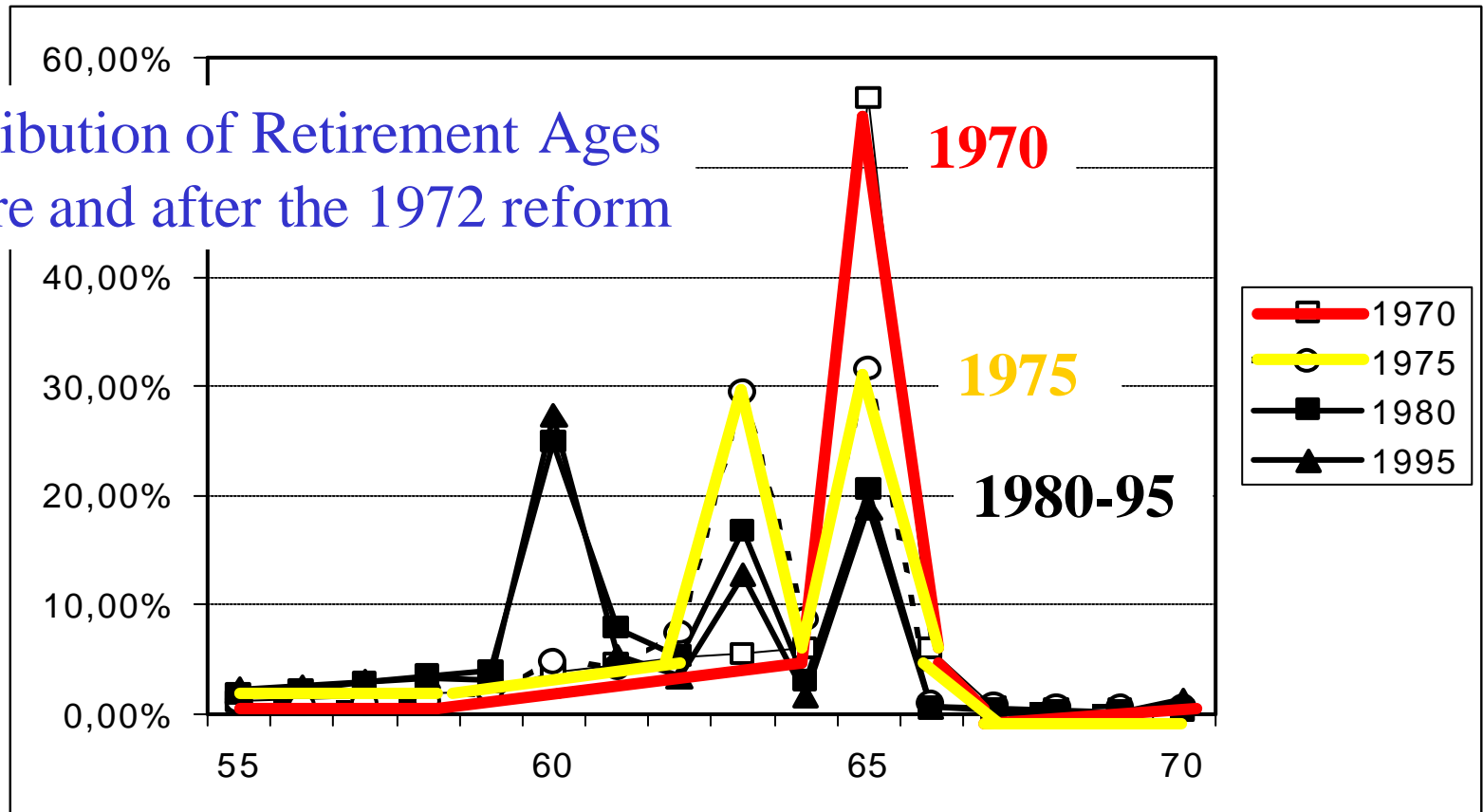


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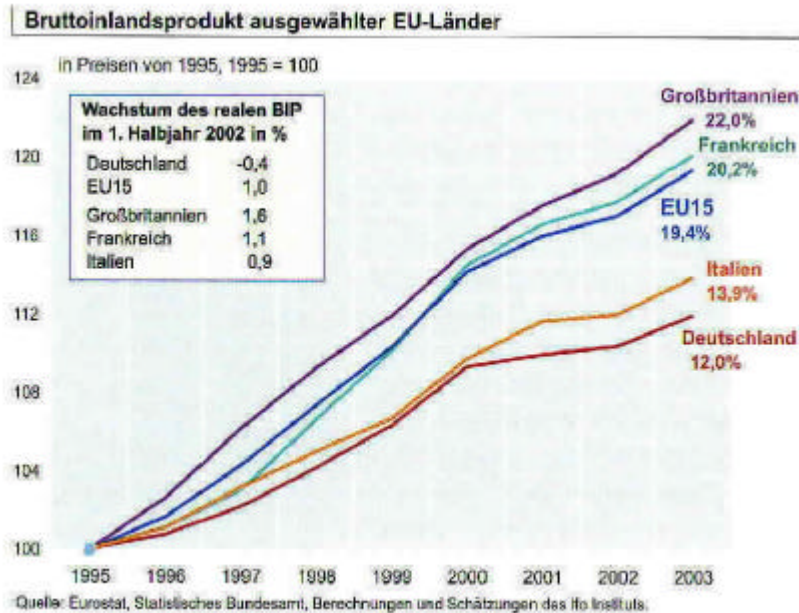
Costly Incentive Effects

Distribution of Retirement Ages before and after the 1972 reform

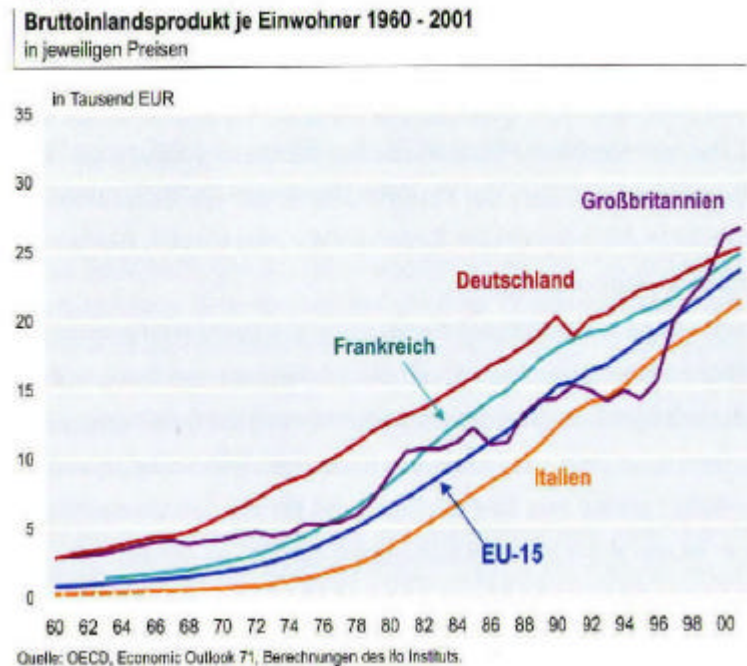


Weak Economic Growth

GDP growth rate:



GDP per capita level:



1. Background: Current state of system

- The German pension system
- Two dimensions of demographics
- Incentive effects
- Economic growth

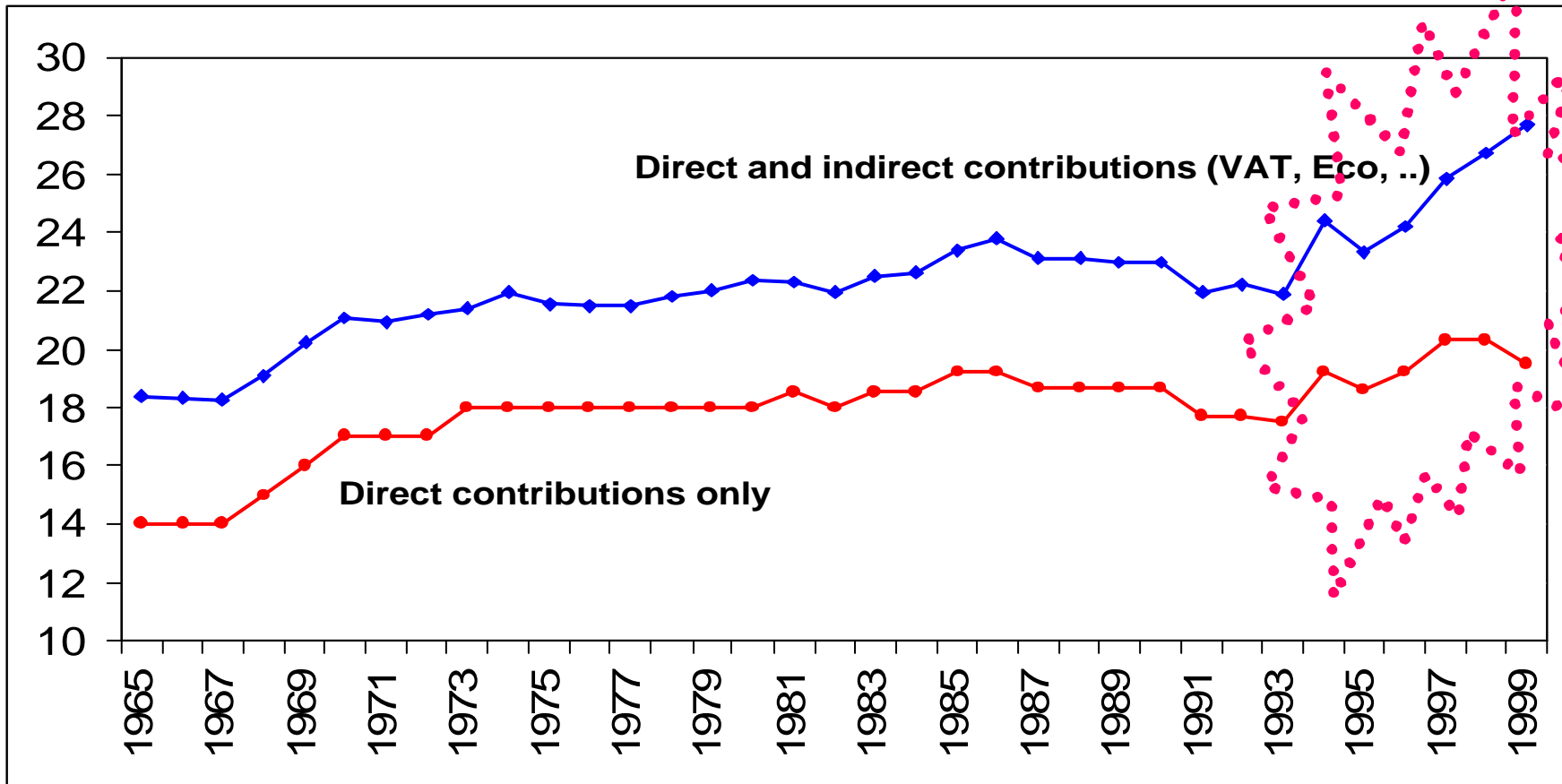
2. Causes and cures

- Growth: Stabilize contribution rates
- Incentive effects: Actuarial adjustments
- Longevity: Shift of retirement age
- Babyboom/bust: Sustainability factor and partial funding

3. The political economy of pension reform

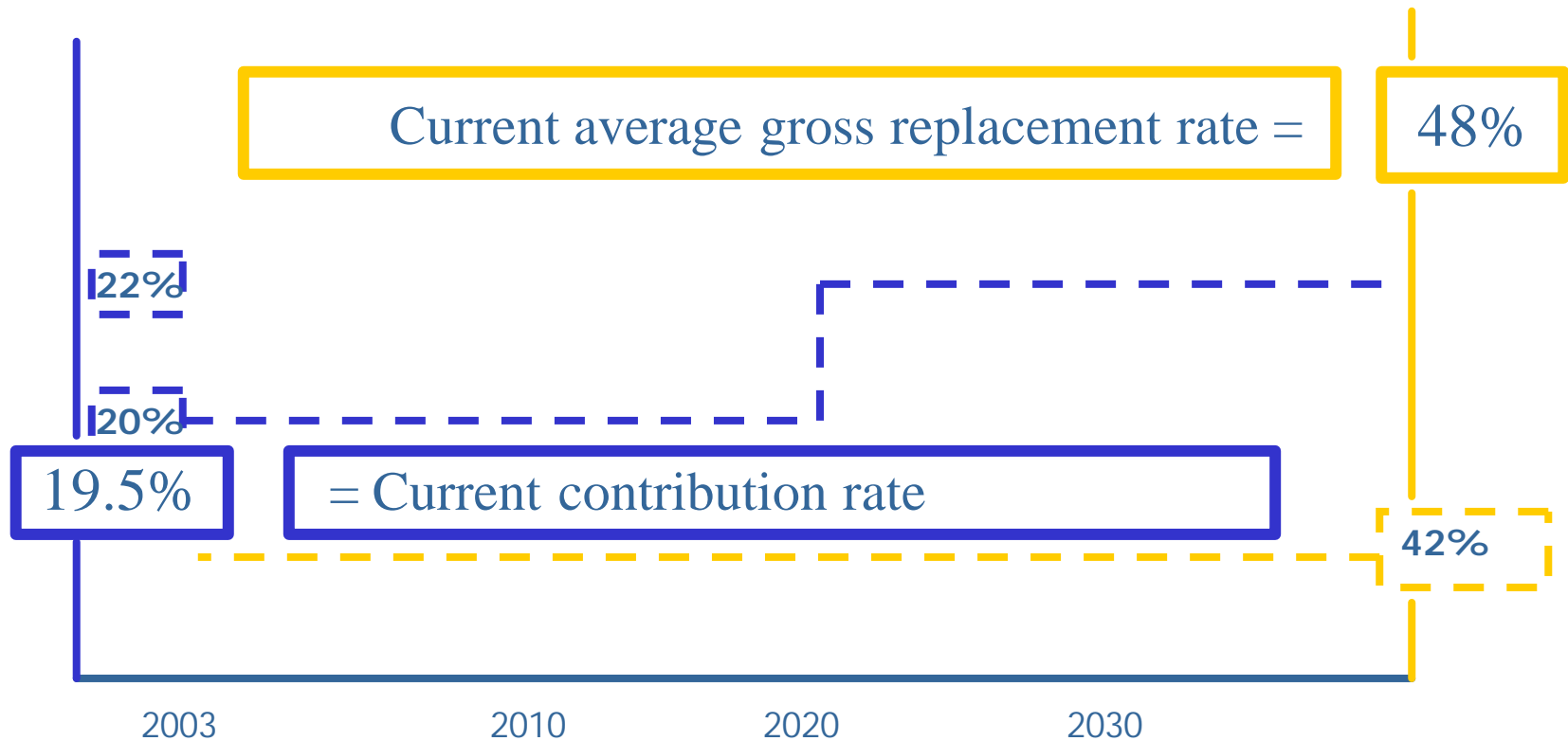
- Short run vs. long-run options
- Possible „deals“

Growth: Stabilize Contribution Rate

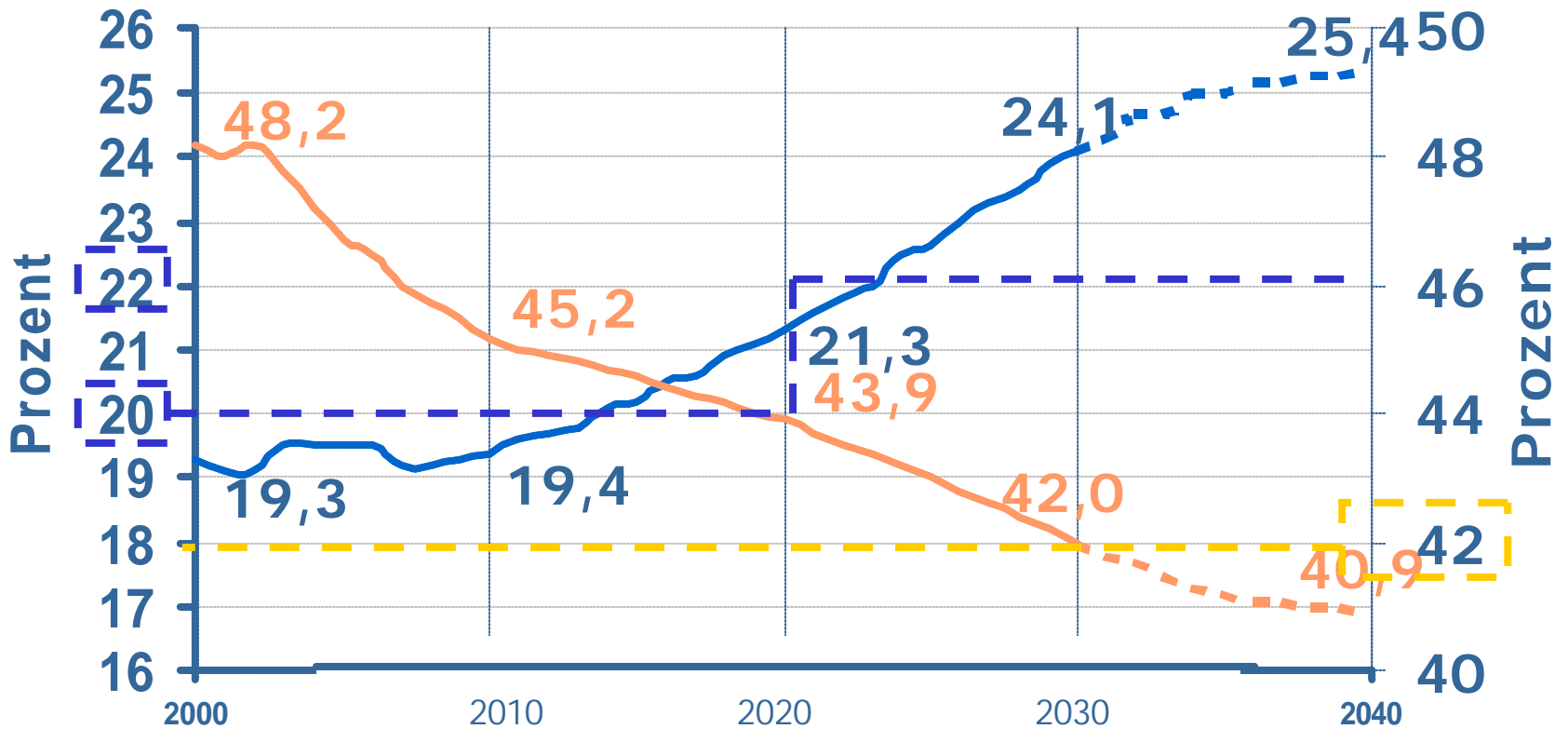


Growth: Stabilize Contribution Rate

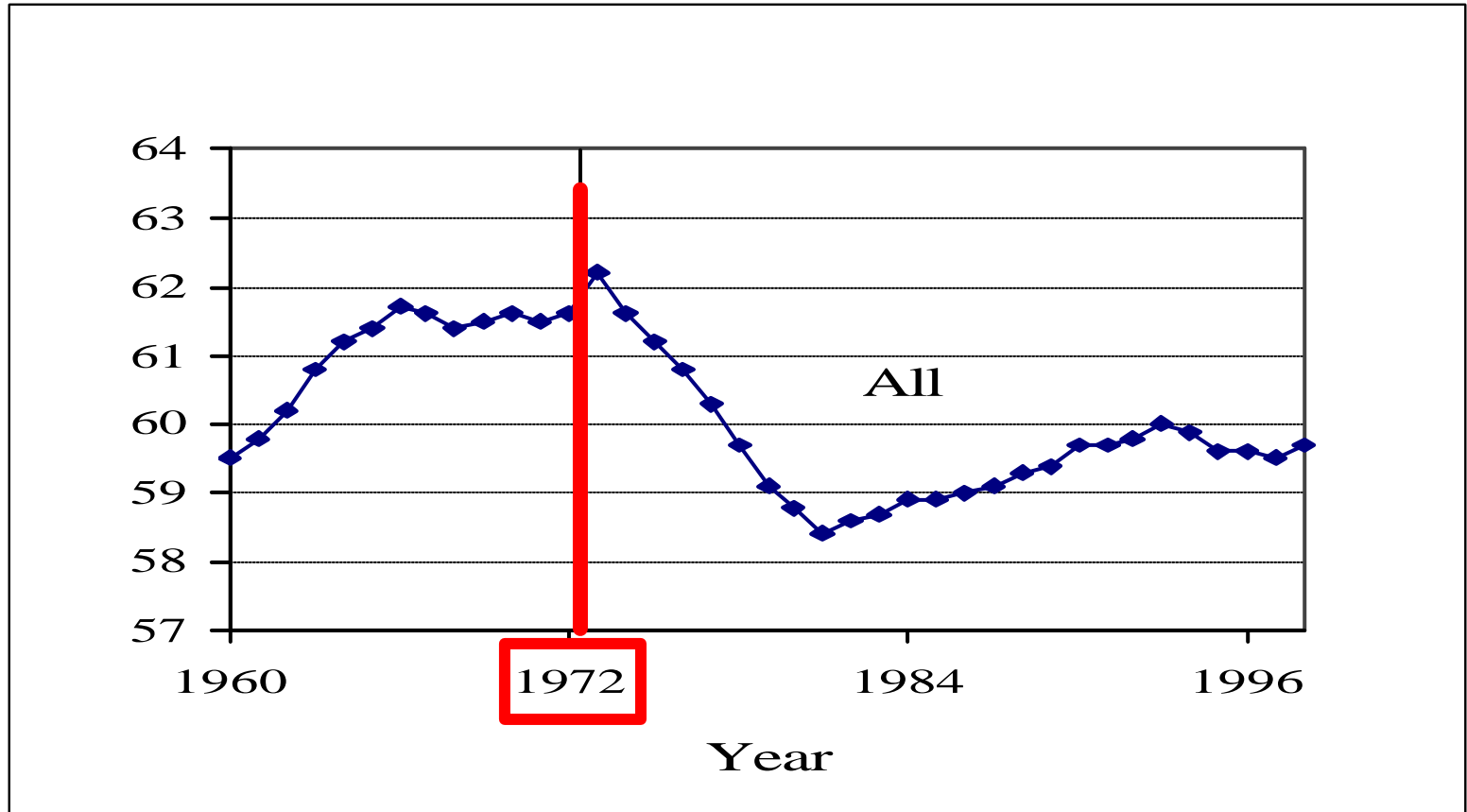
Current *contribution* and *replacement* rates and the Riester Limits:



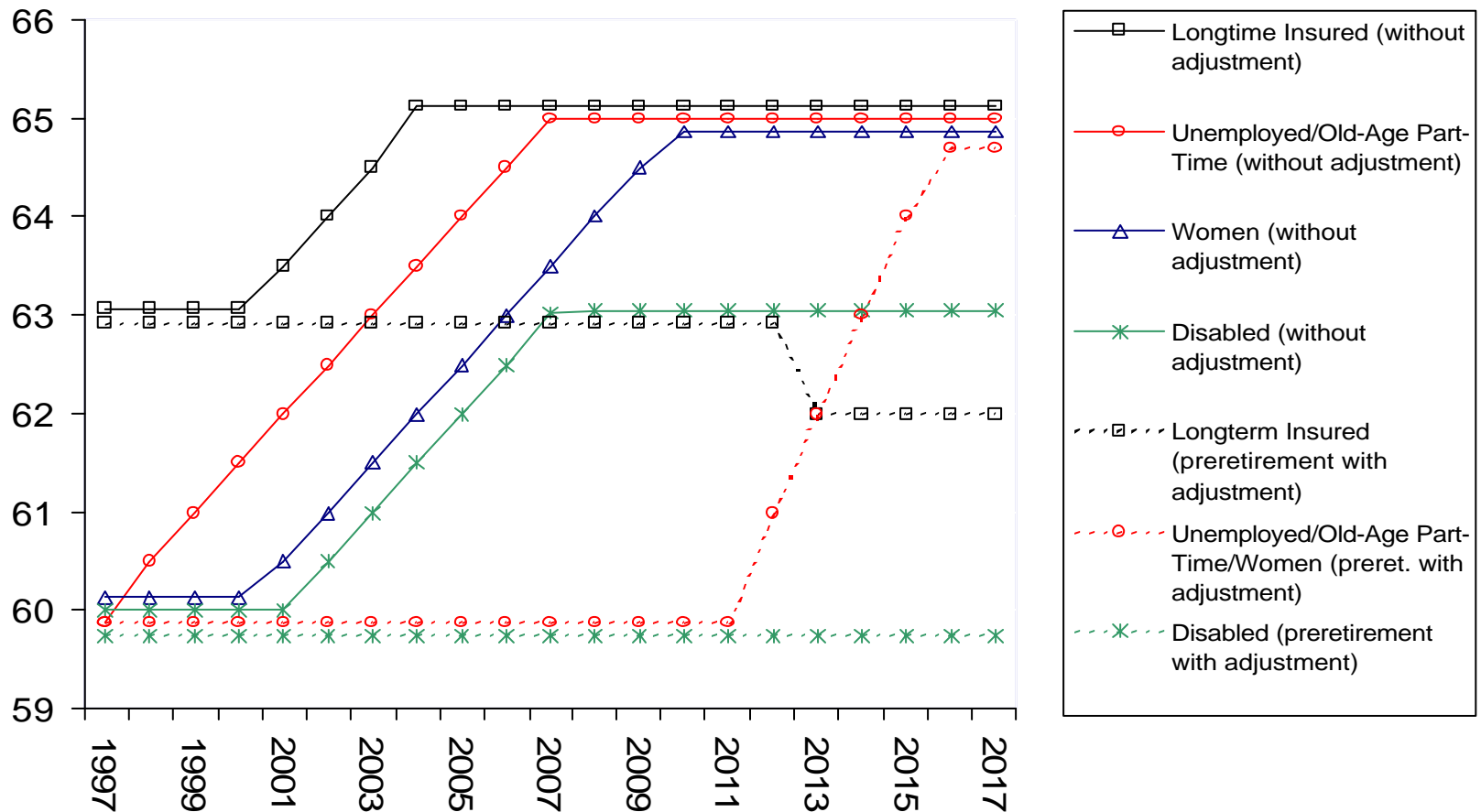
Growth: Stabilize Contribution Rate



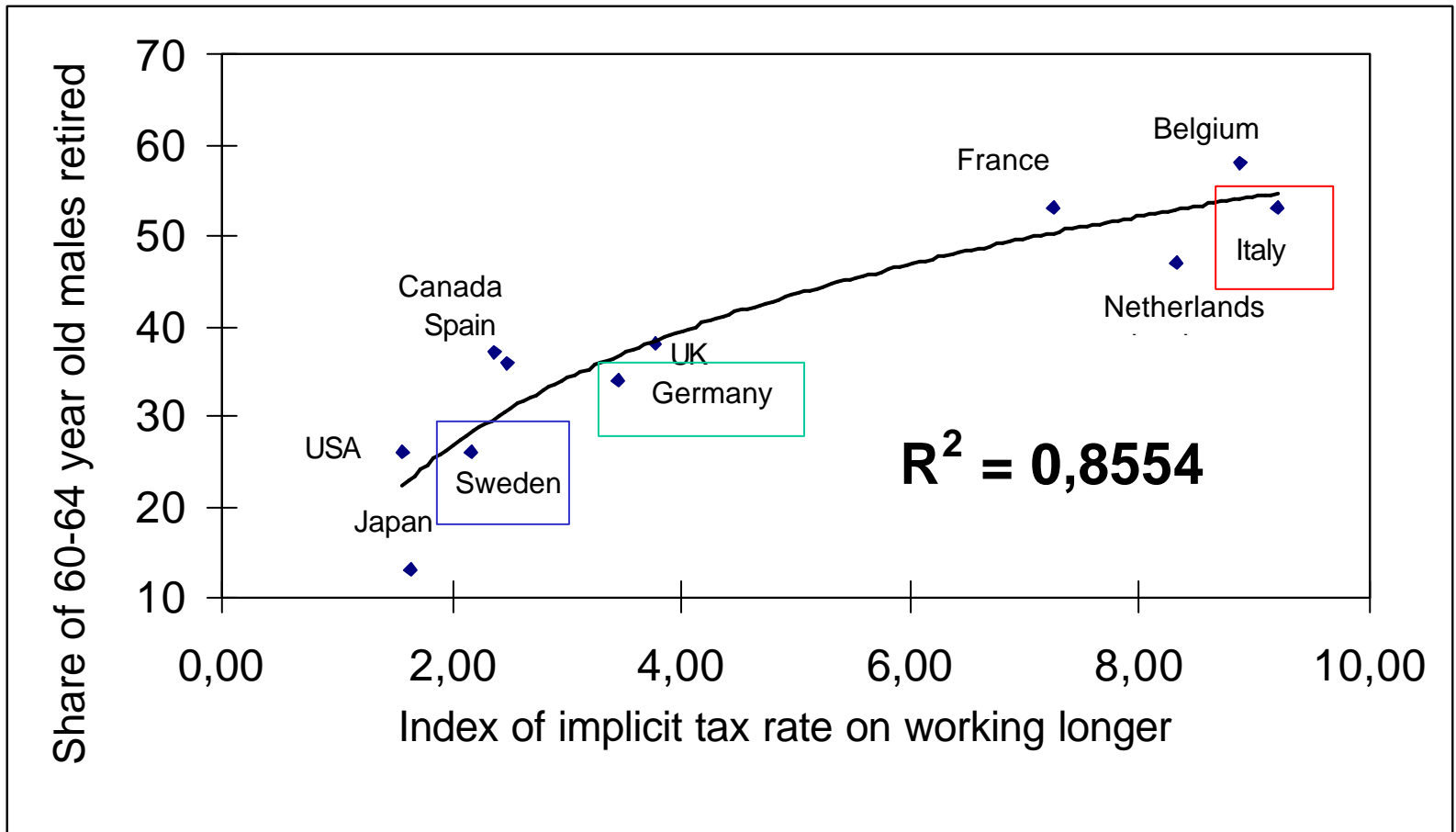
Incentive Effects: Actuarial Adjustments



Incentive Effects: The 1992 Reform



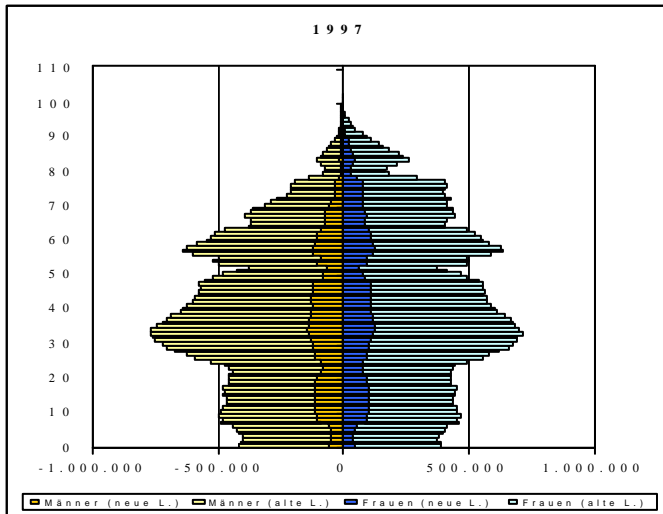
Incentive Effects: Actuarial Adjustments



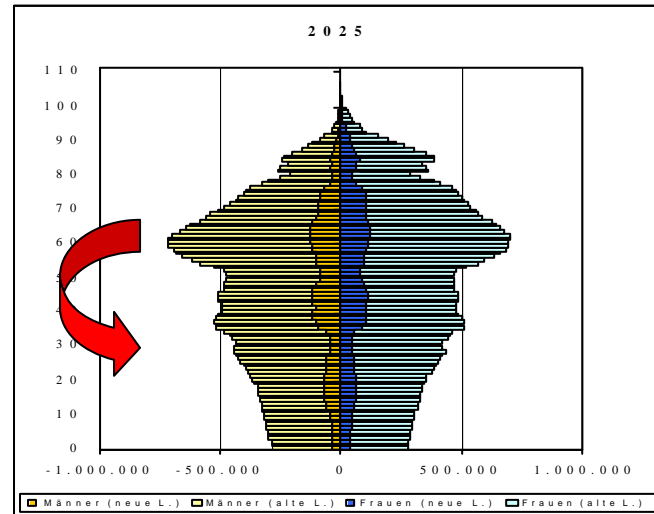
Demographics

Schaubild 1.6
Entwicklung der Altersstruktur der Bevölkerung in den alten und neuen Bundesländern

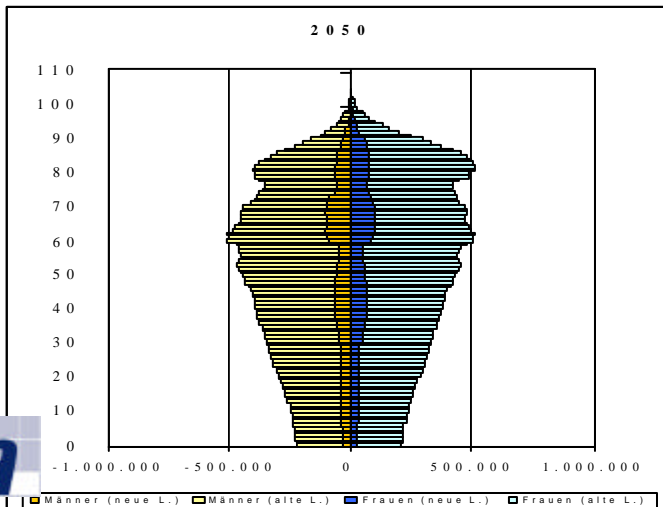
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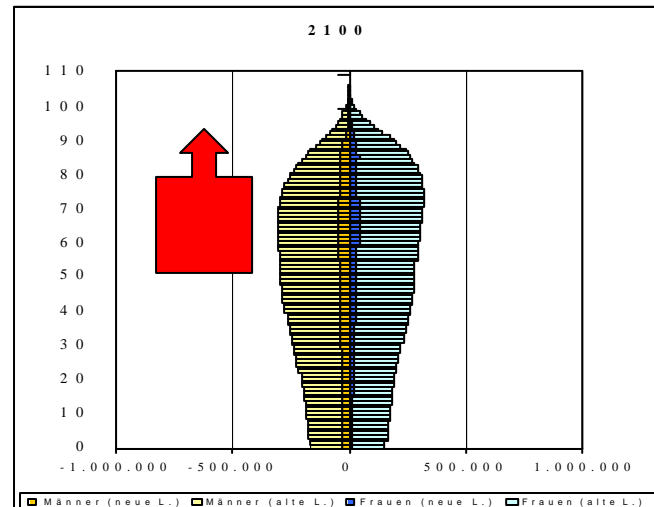
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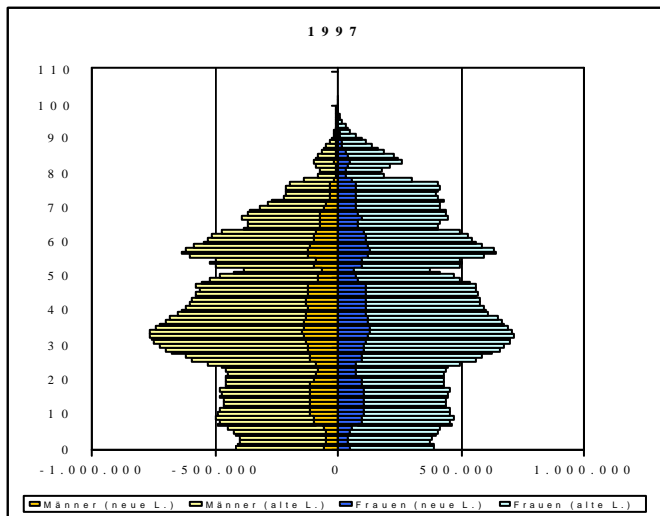
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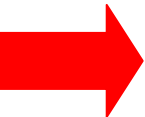
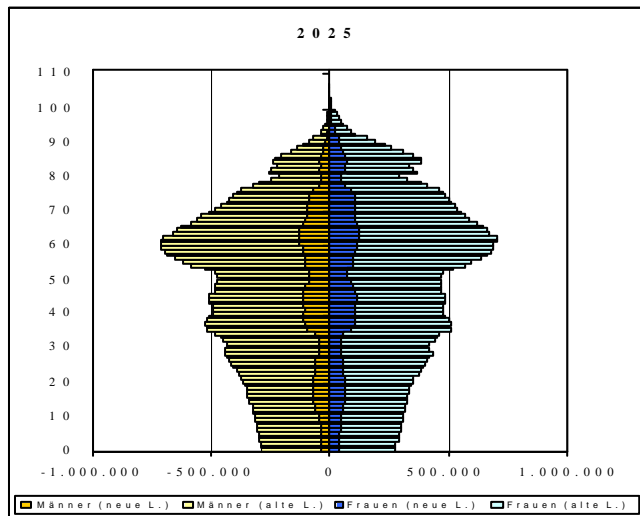
Longevity: Retirement Age

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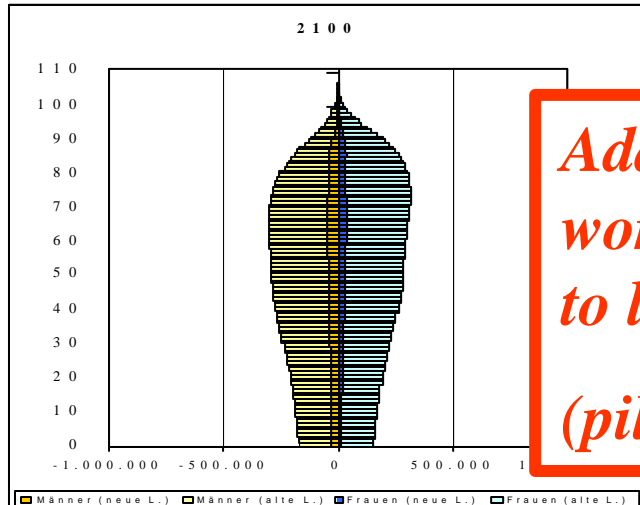
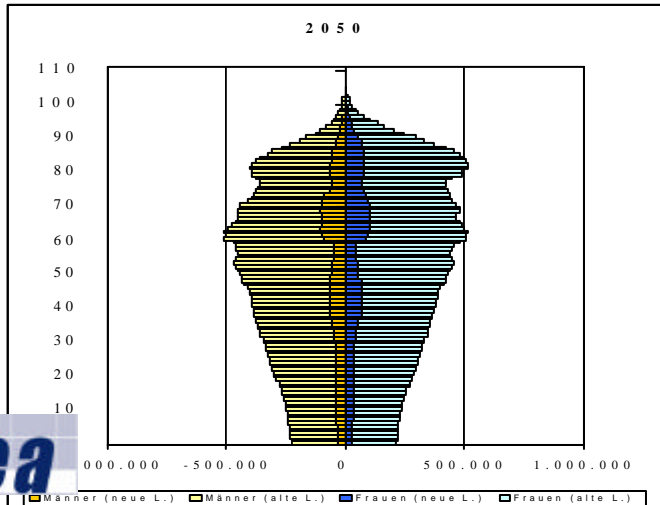
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*Adapt
working span
to life span
(pillar 1)*

Longevity: Retirement Age

Very unpopular

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

Current high unemployment

⇒ cause and effect?

⇒ have a regular check of labor market situation

⇒ put pressure on employers

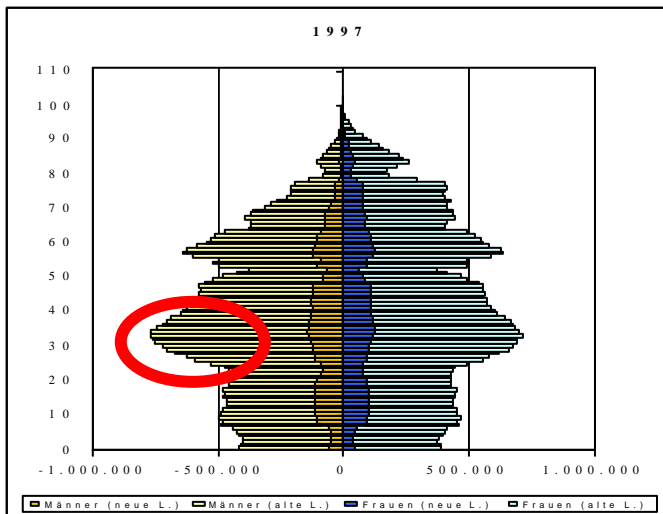
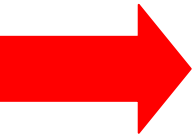
Worn-out argument

⇒ see 1960-72; since then four (healthier) life years more, until 2035 another three years

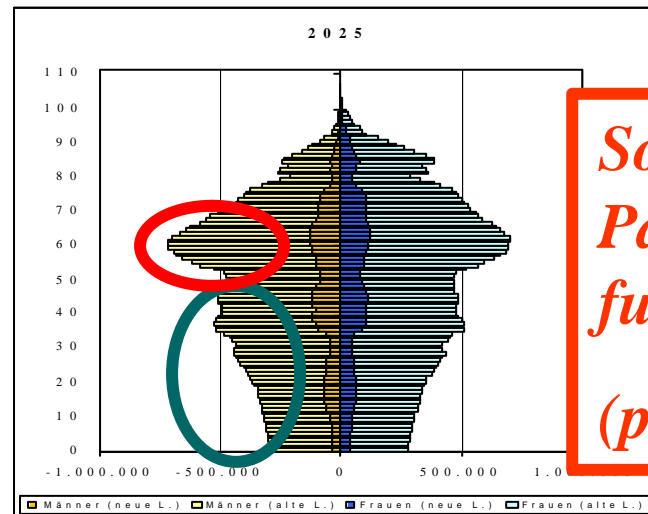
Babyboom/bust: Sustainability Factor

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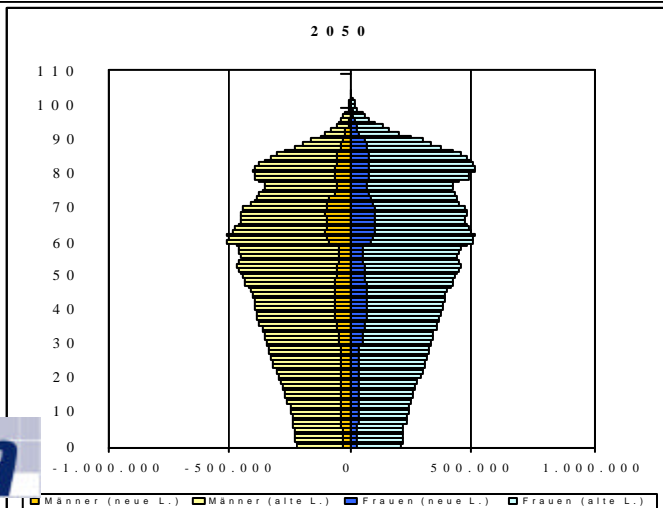


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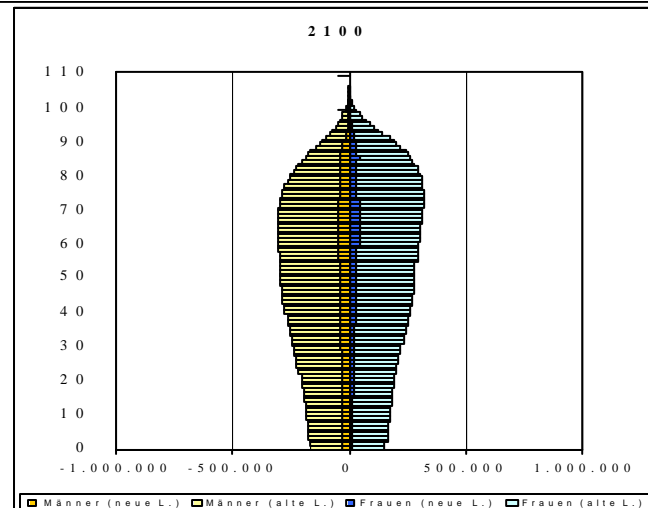


*Solution:
Partial
funding
(pillars 2,3)*

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Babyboom/bust: Sustainability Factor

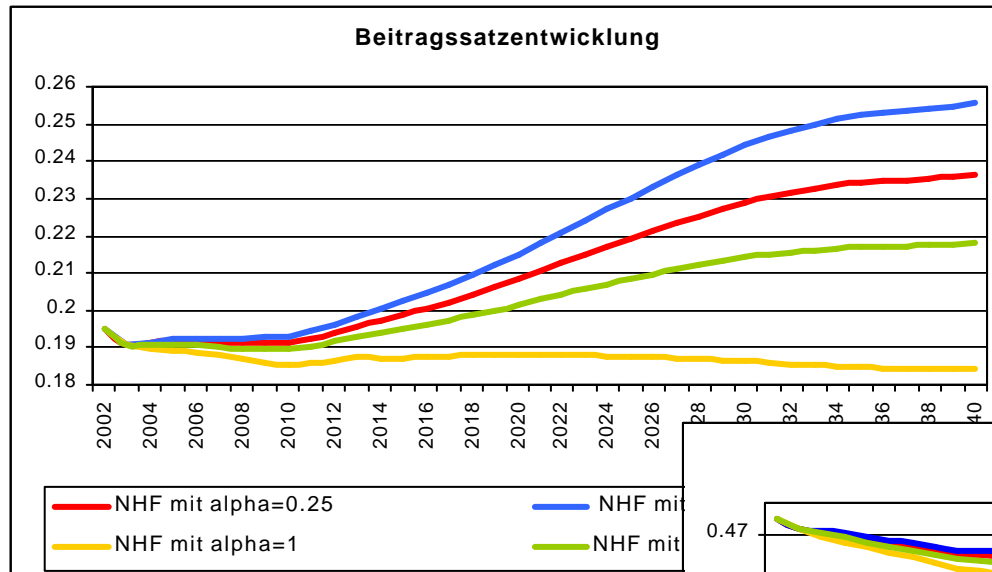
<p>Annual Pension Increase</p>	<p>Change in earnings, net of contributions (aggregate, lagged)</p>	<p>Change in system dependency ratio („sustainability factor“)</p>
$APV_t = APV_{t-1} * \frac{AGE_{t-1} * \frac{1 - CONT1_{t-1} - CONT2_{t-1}}{AGE_{t-2} * \frac{1 - CONT1_{t-2} - CONT2_{t-2}}{SDR_{t-1}}}}{SDR_{t-2}} * \alpha + 1]$		

where:

- APV = average pension value
- AGE = average gross earnings
- $CONT1,2$ = contribution to first and second pillar
- SDR = system dependency ratio (number of equivalence pensioners / number of equivalence contributors)

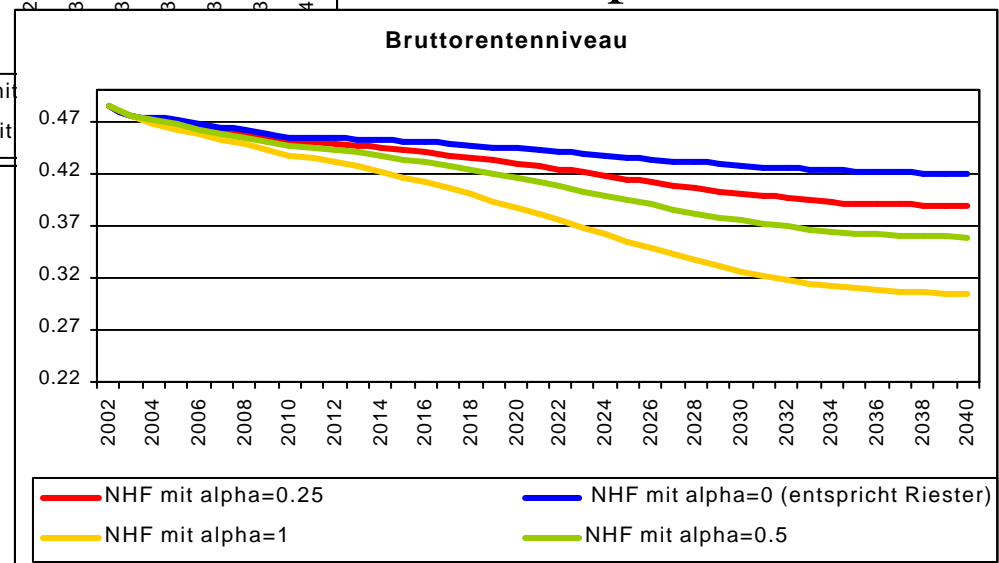
The German pension indexation formula

Babyboom/bust: Sustainability Factor

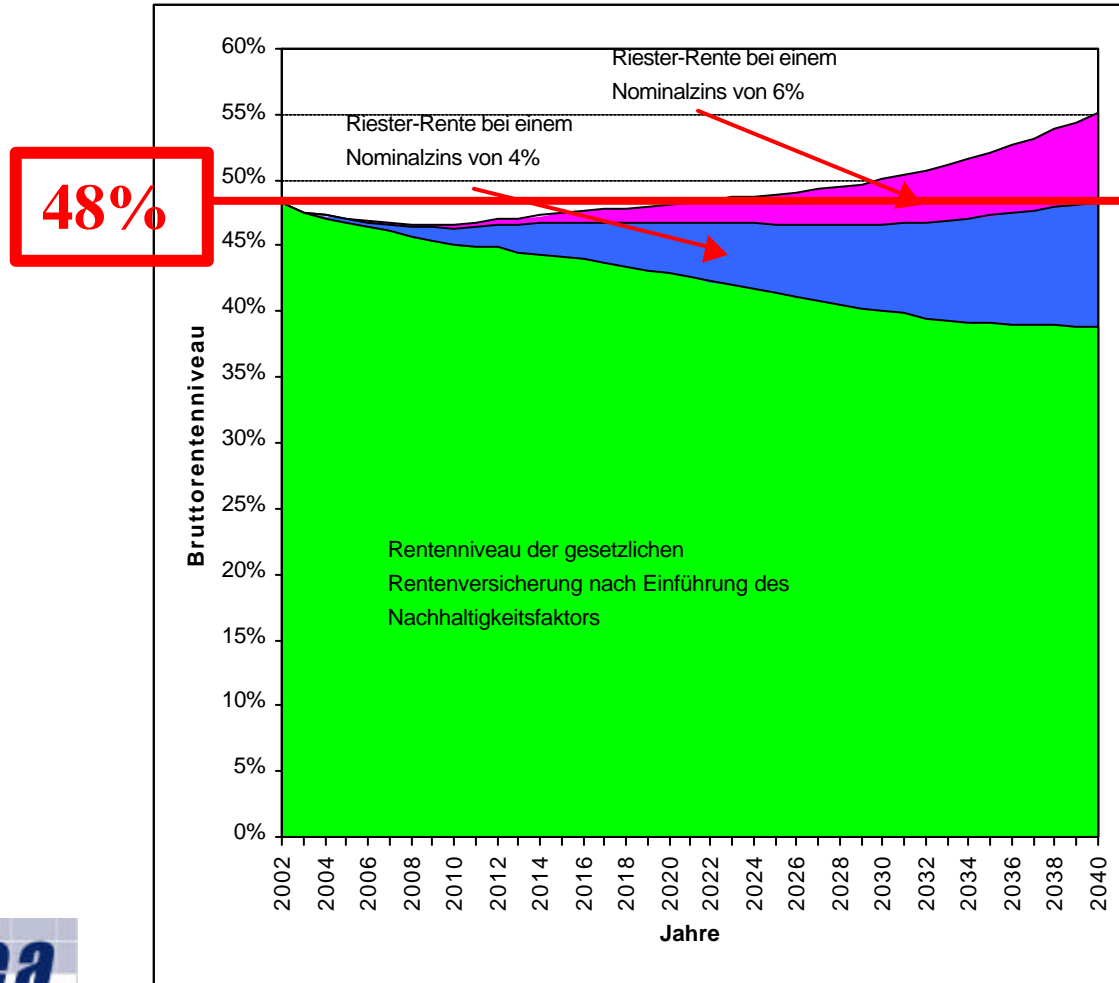


Contribution rate

Replacement rate



Babyboom/bust: Fill gap with private pensions



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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- the German pension system
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- economic growth

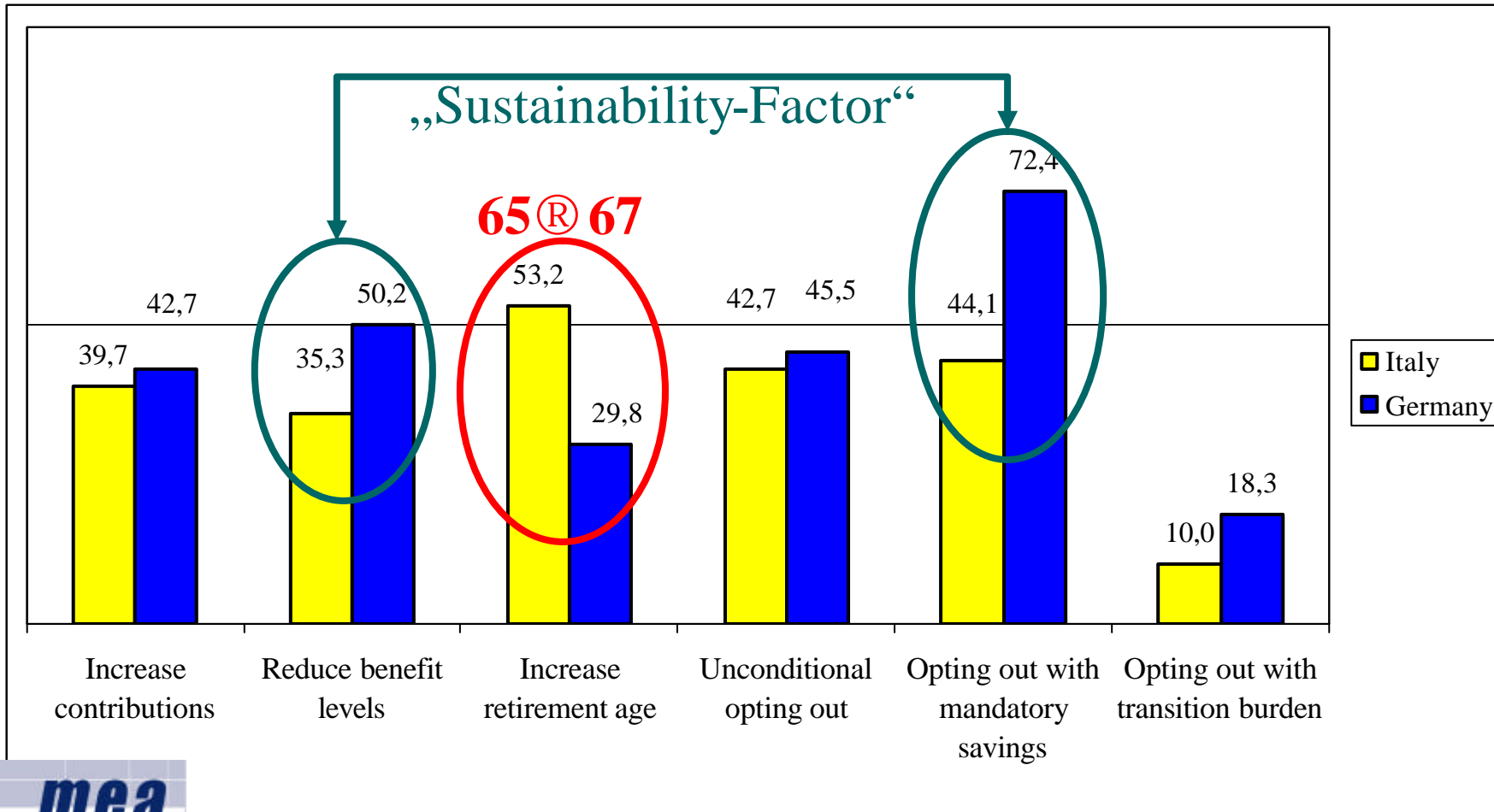
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- growth: stabilize contribution rates
- incentive effects: actuarial adjustments
- longevity: shift of retirement age
- babyboom/bust: sustainability factor

3. Political economy issues

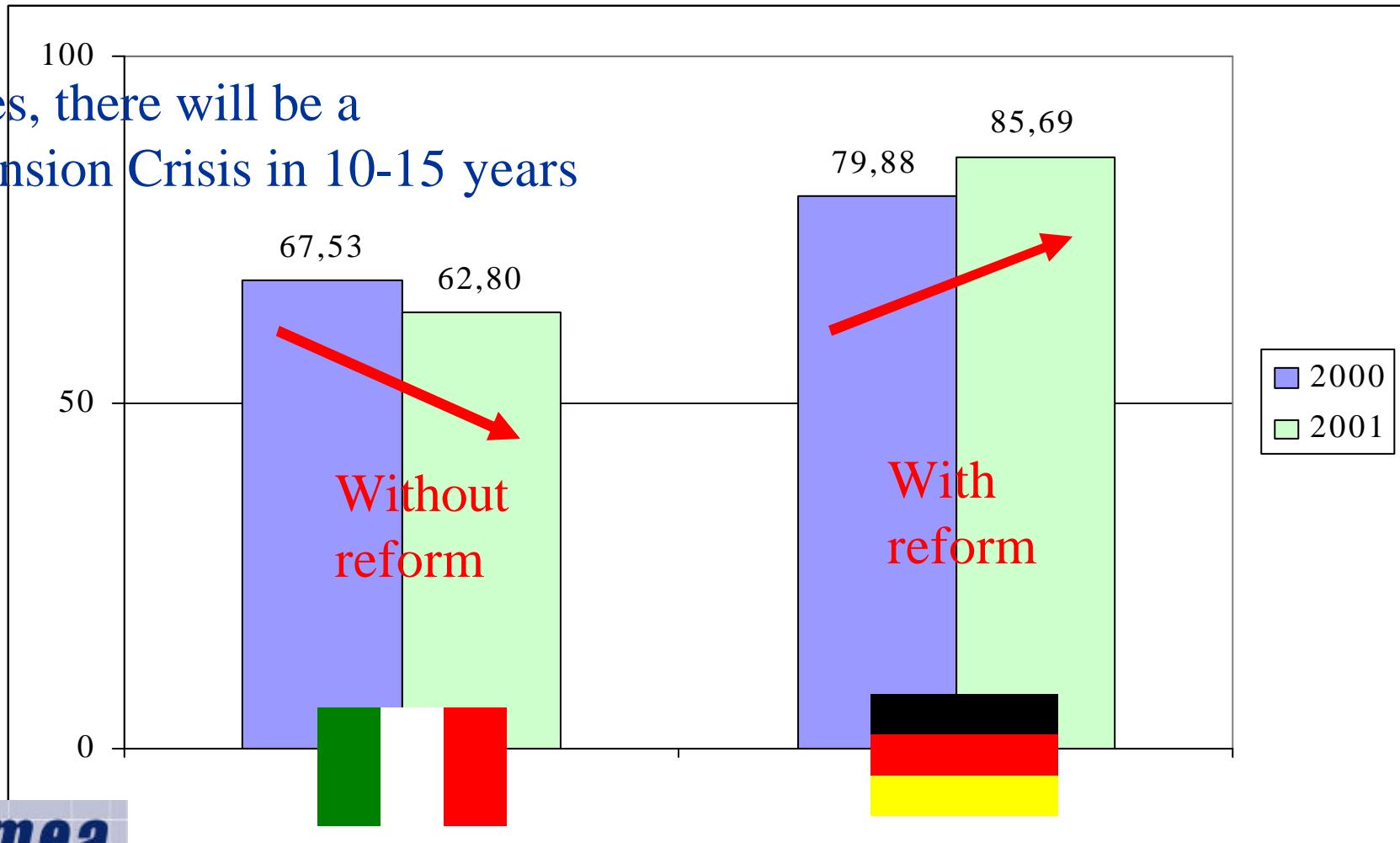
- German vs. Italian situation
- short run vs. long-run options
- possible „deals“?

Preferences vary -- by status quo



Crisis awareness in Germany and Italy

Yes, there will be a Pension Crisis in 10-15 years



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2. Causes and cures

- growth: stabilize contribution rates
- incentive effects: actuarial adjustments
- longevity: shift of retirement age
- babyboom/bust: sustainability factor

3. Political economy issues

- German vs. Italian situation
- Short run vs. long-run options; expectational effects
- Possible „deals“? Long service lives, disability insurance
- Role of employers: quasi-mandatory occupational pension