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PENSIONS:
CORONA REVEALS NEED FOR FURTHER PENSION REFORMS IN GERMANY

08 May 2020

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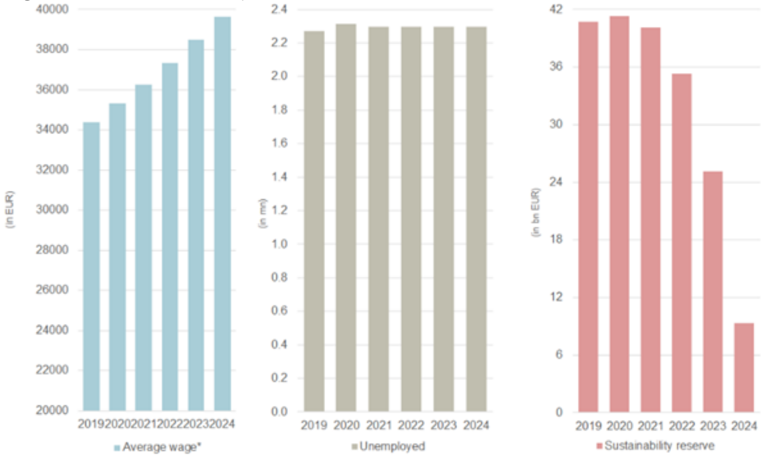
- The Corona pandemic renders the German government's optimistic economic assumptions on which the forecast of the pension contribution rates and the benefit level until 2025 are based, obsolete. Due to short-time work and rising unemployment looms a shortfall of at least EUR 8bn.
- With pension cuts prohibited by law, an increase of the contribution rate can only be avoided by depleting the sustainability reserve faster than planned.
- Against the background of the accelarating aging of society, it needs sufficent capital buffers and further pension system reforms.

In the tailwind of a favorable economic environment and the retarding aging of society, the German government has in recent years not only granted generous new pension benefits but promised also to keep the pension level[1] stable at 48% and the pension contribution rate below 20%, at least until 2024. In fact, in the last autumn's mid-term estimate, the government was optimistic that the contribution rate could be held stable at 18.6% until 2024. However, this calculation was based on the assumption that the average number of unemployed would remain at around 2.3mn per year and the average contributory salary in the old federal states would increase by 2.7% this year and next year and by an average 3.0% between 2022 and 2024. The respective assumptions for the wage development in the new federal states were even 0.2 percentage points higher. Furthermore, it was decided to decrease the sustainability reserve gradually from a comfortable EUR 40.5bn at the end of 2019, which corresponded to the expenses of 1.8 months, to a mere 9.3bn or 0.3 monthly expenses until the end of 2024.

[1] Net before tax.

Figure 1: Main assumptions of the mid-term estimate, autumn 2019



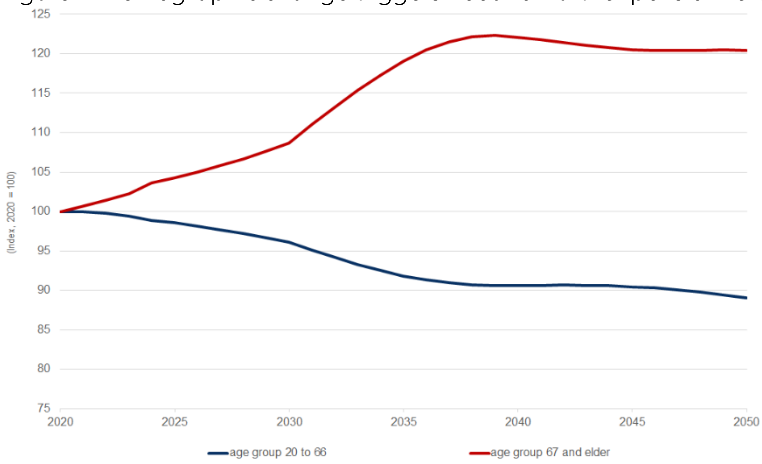
*here: West Germany, average contributory salary per year

Source: Deutsche Rentenversicherung.

However, due the Corona pandemic, the number of short-time workers could peak at a record 12mn and leave an average 2.7mn unemployed this year. Assuming that in the course of this economic downturn, the average monthly wage increases merely by 0.1% – what is still optimistic as it would mimic the development of the financial crisis in 2009 – contribution income in 2020 could be around EUR 8bn lower than expected in the mid-term scenario. However, thanks to the bumper years before Covid-19, this amount could be still balanced by means from the sustainability reserve, although it already declined to EUR 38.3bn in March, last but not least due to decreases in contribution income and increases in pension expenditures.

Bottom line: The Corona crisis will deplete the sustainability reserve earlier than assumed, triggering the need for contribution rate increases, as pensions cannot be cut by law, despite the fact that the formula to calculate the current pension value takes into account changes of the average wage and of the ratio of "equivalent pensioners" to "equivalent contribution payers". The other option would be to increase the share of state subsidies further to maintain the illusion that higher pension expenditures do not necessarily implicate higher contribution rates. But against the spectre of rising public debt post Covid-19 and rapid aging, this might proof to be rather short-sighted.

Figure 2: Demographic change triggers need for further pension reform



Source: Statistical Office of Germany.

What does it mean for society? Within the next 30 years, the age group of people in retirement age is expected to grow by 3.6mn or 20%, while the number of people in working age is set to shrink by 5.5mn or almost 11%. However, this development will gain momentum only after 2030, thus still leaving a window for reforms. Hence, a honest public debate about necessary increases of contribution rates, the retirement age and the future level of pension benefits is necessary. Otherwise, the next economic crisis will hit a pension system with depleted reserves and no room to balance temporary declines in contribution income.

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