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SAFE Finance Blog

Additional Gainful Employment must be Worthwhile with the Pension

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Alexander Ludwig: The discussion about lower delayed retirement credits in the German public pension system misses the point. Instead, it would be more important to increase both, delayed retirement credits and early retirement penalties, and to link them to the longer life expectancy of the working population

If employees work beyond the normal retirement age, it strengthens the potential economic performance of the economy. At the same time, employees benefit from the additional gainful employment too: according to the current legal regulations, they receive a delayed retirement credit of six percent for each additional

year of work, for the entire period of entitlement. Economists at the Kiel Institute for the World Economy (IfW) (https://www.ifw-kiel.de/de/publikationen/kiel-focus/2019/wer-laenger-arbeitet-entlastet-das-rentensystem-wirklich-0/) recently took a closer look at the effects arising for the pension system.

According to them, the additional employment under the current legal regulations is at least double-edged for the pension system. The result of their calculations is that the longer work of pension insured persons over the standard retirement age, given the current life expectancy, is in itself a loss-making business for the pension system, which leads to lower pensions and higher contribution rates. Therefore, in their comment they suggest, firstly, reducing the surcharges in the pension insurance and, secondly, linking them to further life expectancy. The article states: "Specifically, the value of six percent should be reduced. In addition, the percentages for the respective additional years of work should be staggered in ascending order".

What is to be thought of this initiative? In my opinion, the first proposal is misleading and distracts from the actual problem of adjustment factors, either as early retirement penalties or late retirement credits. The second one, a staggering approach and thus a link to longer life expectancy, from my point, indeed makes sense.

Firstly, the structure of late retirement credits depends on the perspective, as this contribution (http://mea.mpisoc.mpg.de/uploads/user_mea_discussionpapers/smd5ttcgzlchikl6_smd5ttcgzlchikl6_prcmob_ in a value-neutral way. I would like to make an assessment: the perspective of the individual, an incentive-oriented one, seems to me to be the appropriate one after all consideration. The reason is that pension insurance from an ex-ante perspective, so before entering working life at a young age, contains numerous insurance elements, which justifies an overall low return on the pension insurance. However, from the ex-post perspective, that means shortly before retirement, this is not the case: around the retirement period, insurance elements such as basic provision for old age, survivors' pension or reduced earning capacity pension are largely irrelevant, that only incentive compatibility should count. And this would require higher surcharges if the additional gainful employment should pay off on an individual basis.

The IfW economists' recommendation distracts from the actual problem: more relevant are the too low penalties for early retirement of currently three percent, as well as the jump from three percent penalties to six percent credits at the statutory retirement age. It would make sense to replace this regulation with a continuously increasing function that starts at an average level higher than three percent - so higher reductions for early retirement - and ends at a slightly higher level than today's six percent (around seven to eight percent). This should apply on average, as the increases and reductions should be linked to the long-term life expectancy of men and women. Women aged 65 have a life expectancy of about 86 years according to current figures, while men have a life expectancy of about 83 years. In 20 years it will be about 88 years for women and 86 years for men (Calculated on the basis of United Nations data (http://www.un.org/en/development/desa/population/)). For simplicity, cross-sectional data are used here. Correctly, the indexing should be done by the life expectancy of the corresponding cohorts). Since women live and receive a pension longer, they should receive lower rates.

It is also important to stress that this calculation does not include the positive effects of higher employment in old age on overall economic activity. From this perspective, penalties and credits based on individual incentive aspects are still at a lower limit.

Moreover, as proposed by the IfW economists, this function should be linked to the more long-run remaining life expectancy. The coordinated population forecast (https://www.destatis.de/EN/FactsFigures/SocietyState/Population/PopulationProjection/PopulationProjection.h of the Federal Statistical Office (Destatis) provides information on this. Finally, other pension insurance

variables are also linked to statistical values, such as the sustainability factor. Similarly, the standard retirement age is implicitly linked to life expectancy. Instead of a fixation as provided for by current legal legislation, direct indexing would also be more sensible here, as it automatically adapts to new forecasts.

Such indexing would be close to what an insurance company would sensibly do. If the long-run life expectancy were to rise further, the penalties and credits would automatically fall, and vice versa, if life expectancy were to fall, they would rise.

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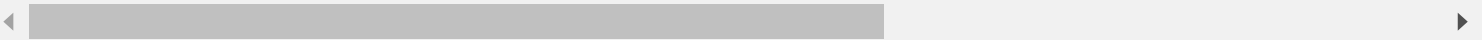
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