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Sustainable Architecture for Finance in Europe (<https://safe-frankfurt.de/>)

SAFE Finance Blog

Four Measures for a Sustainable Pension System

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Alexander Ludwig: Demographic prospects require fundamental reforms



A new German government for the next four years is about to be formed. One major topic this government has to deal with is a fundamental reform of the German pension system. Given the demographic prospects, we will face contribution rates of up to 25 percent and a decrease in the gross pension level down to about 36 percent in 2040 if there are no major reforms in the next years. Pension scenarios brought forward during the election campaign based on calculations only until 2030 do not meet the challenges ahead.

Here are four measures that should be implemented:

Firstly, the retirement age needs to be linked to life expectancy so that the proportion of lifetime in work and lifetime in pension remains constant on average. In addition, the retirement age should no longer be a

and income in pension remains constant on average. In addition, the retirement age should no longer be a strict legal category but rather a reference point for premiums and deductions. In particular, we need to sanction early retirement with larger deductions. Also, if officials decide that it is desirable to keep in place the current early retirement legislation without any deductions after a certain number of years of contributions, 45 at the moment, this number has to increase with life expectancy too.

Secondly, this measure should be accompanied by a tax-funded minimum pension at the level of the unemployment benefit (ALG II) in order to fight old age poverty. The minimum pension should be subject to the condition of a certain number of years of contributions or, at least, the search for such employment in Germany.

Thirdly, the pension formula should become more progressive, like it is in the United States. Research shows that the pension scheme is very well suited to insure lifecycle earning risks by redistributing between people with high and low lifetime incomes. Such a redistributive scheme would also effectively adjust total pension payments to account for the difference of seven years in remaining life expectancy at age 65 between low and high income earners. This kind of redistribution would not entail significant negative work incentives.

Fourthly, the promotion of the private old age provision which has been gradually introduced since 2003 needs to be amended. Its dissemination is too low and the bureaucratic burden too high to really serve as compensation for an ever smaller public pension level. Therefore, the subsidies should be abolished and steadily replaced by a mandatory private savings scheme which could be implemented as a market solution, as, e.g., in Australia. Most importantly, all guarantees in the accumulation phase for certified products need to be eliminated in order to allow for higher yields.

Given that the baby boomers retire in the 2020s, the next legislative term is the very one to give the German pension system a sustainable set-up.


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