The German Statutory Pension Insurance (Gesetzliche Rentenversicherung)

Mechanism Design, Demographic "Greying," and the Rentenpaket II Paradigm Shift

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Agenda

1. **Introduction:** The Economic Trilemma & Theoretical Foundation
2. **System Design:** Institutional Structure, Points System, and Pension Formula
3. **Supplementary Pillars:** Occupational and Private Pensions
4. **Demographic Challenges:** Aging Population and Labor Market Responses
5. **Current Reforms:** Rentenpaket II and the *Generationenkapital*
6. **Outlook:** Remaining Problems and Conclusion

The Economic Trilemma & Mackenroth's Theorem

The Fundamental Constraint: The "Pension Trilemma."

- **Contribution Rate** (*Beitragssatz*): How much workers pay. Politically capped (approx. 20-22%)
- **Replacement Rate** (*Rentenniveau*): How much pensioners get. Politically protected (floor at 48%)
- **Retirement Age**: How long you work. Also politically sensitive

You can only fix two; the third must adjust. Germany is trying to fix all three.

Theoretical Basis: *Mackenroth's Theorem (1952)*:

> *"All social expenditure must always be paid out of the current national product."*
> *(Goods for retirees are made by current workers, regardless of funding type)*

Institutional Design: A System Reliant on One Pillar

Structure:

- **Pillar 1 (GRV):** Mandatory Pay-As-You-Go (PAYG)
  - Covers ∼90% of the workforce, providing ∼75% of old-age income, but notably EXCLUDES civil servants (*Beamte*), who have a separate, state-financed pension system
  - **Result:** A "mono-pillar" system, highly exposed to demographic shifts
- **Pillar 2 (bAV) & 3 (Private):** Voluntary and have seen limited uptake

Financing:

- Contributions (Employer/Employee split 50/50)
- **Federal Subsidy (Bundeszuschuss):** ∼20% of the budget comes from general taxes, not contributions

Pillar 1: The "Points System" (*Entgeltpunkte*)

The Logic: Your pension reflects your lifetime relative income, it's not a "final salary" system.

- **Accumulation Mechanism:**

$$EP_t = \frac{\text{Individual Gross Income}_t}{\text{Average Gross Income}_t}$$

Example (2024): The provisional average income is ∼€45,400. Earning this amount gets you 1.0 point. Earning €68,100 gets you 1.5 points

- **Incentive Structure (The Equivalence Principle):**
  - Strict linearity (*Contribution* $\propto$ *Benefit*)
  - **Economic Goal:** Makes contributions feel like "deferred wages," not a tax, to minimize labor supply distortions

The Pension Formula: Turning Points into Euros

The Equation:

$$\text{Pension}_{\text{Monthly}} = \sum EP \times ZF \times RAF \times AR$$

Variables:

- $\sum EP$: Your total lifetime earnings points
- ZF (Access Factor): An early retirement penalty. 0.3% permanent cut for every month you retire before the statutory age
- RAF: Pension Type (1.0 for standard old age)
- AR (Current Pension Value): The "exchange rate" for one pension point. As of July 2024, its value is **€39.32**

Pillar 2: Occupational Pensions (*Betriebliche Altersversorgung - bAV*)

Scope:

- Company-sponsored pension schemes, typically covering only employees of larger firms
- Voluntary system with tax incentives for both employers and employees

Relevance: Despite tax incentives, coverage remains limited:

- Only ∼50% of employees have access to occupational pensions
- Coverage is concentrated in large companies and public sector
- Small and medium enterprises (SMEs) rarely offer bAV
- **Result:** Provides only ∼5-10% of total old-age income, far below the intended complement to Pillar 1

Pillar 3: Private Pensions (*Riesterrente*)

The Concept: State-subsidized private pension savings (introduced 2001)

Why Low Uptake?

- **Complexity:** Multiple product types, confusing eligibility rules, and bureaucratic application processes
- **Low Returns:** High fees and conservative investment strategies erode returns, making it unattractive compared to alternatives
- **Means-Testing Penalty:** For low-income savers, Riester benefits are offset by reductions in *Grundsicherung*, creating a 100% effective marginal tax rate
- **Trust Deficit:** Public skepticism about private financial products after financial crises

Reality: Only $\sim$16 million contracts (out of 45 million eligible)

The Demographic Time Bomb is Ticking

- This rule-based static system now faces a massive exogenous shock: demography
- By 2035, the last of Germany's "Baby Boomer" generation will have retired
- The Old-Age Dependency Ratio (OADR) is projected to soar from 35 to over 50
  - **Today:** $\sim$3 workers support 1 pensioner
  - **By 2050:** $\sim$2 workers will have to support 1 pensioner
- **The Fiscal Squeeze:** Without reform, the contribution rate is forecast to rise from 18.6% to over 24% by 2040

The "Generational Contract" is under unprecedented stress.

Labor Supply & The Politics of Retirement Age

- **Policy Response: "Rente mit 67" (2007 Reform)**
  - Gradually increases the Statutory Retirement Age (SRA) to 67 by 2031 to keep people working longer
- **The Policy Anomaly: "Rente mit 63" (2014)**
  - Allowed long-term contributors to retire early without penalty
  - **Economic Critique:** A huge "deadweight loss" by subsidizing the exit of highly productive, skilled labor during a growing labor shortage
- **Result:** The effective retirement age (64.7) remains below the statutory age

The Sustainability Factor: Shifting Risk by Dampening Growth

The Goal: Automatically adjust for demography

- Given the demographic pressure, the formula has a built-in endogenous adjustment mechanism
- **The Dampener: The Sustainability Factor (enacted 2004)**
  - If the dependency ratio (pensioners/workers) worsens, pension increases are "dampened" and do not fully follow wage growth
  - **Crucial Distinction:** This factor does **not** cut nominal pensions. It reduces the annual *rate of increase* of the pension value (AR), making it lag behind national wage growth

$$AR_t \approx AR_{t-1} \times \text{WageGrowth}_t \times (1 - \alpha \cdot \Delta R_t)$$

where R_t is the pensioner-to-contributor ratio

The "Standard Pensioner" & Falling Replacement Rates

- These pressures and adjustments have direct consequences for the key political trade-offs
- **Standard Pensioner ("Eckrentner"):** A theoretical person with 45 years of average contributions
  - **Problem:** This ignores fractured careers and part-time work, thus painting a deceptively rosy picture
- **Replacement Rate Trends (The Worry):**
  - The net replacement rate is currently held at $\sim$48%
  - *Forecast:* The Sustainability Factor would have caused it to drop to 45% by 2040
- **Contribution Rate Trends (The Other Worry):**
  - Currently $\sim$18.6%
  - *Forecast:* Set to break the politically sensitive 20% barrier by 2028

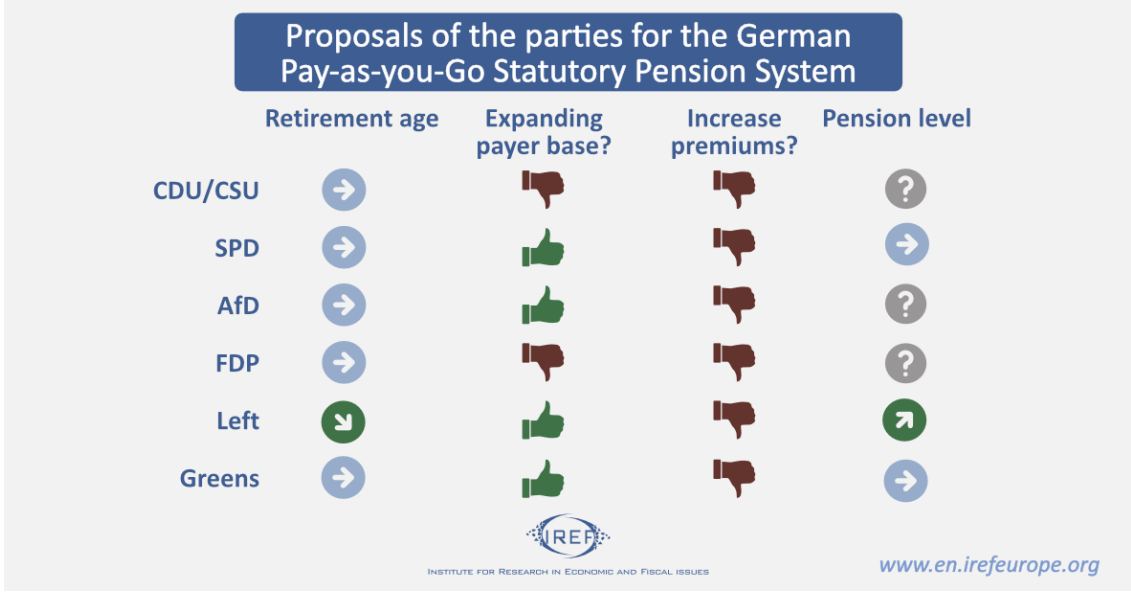
The Social Safety Net

The Reality for Low-Income Pensioners:

- **Problem:** A low statutory pension level can lead to old-age poverty. The average monthly pension for those with 35+ years of contributions ranges from ∼€1,460 (women) to ∼€1,890 (men)
- **The Floor: Basic Income Support**
  - A means-tested social welfare benefit that acts as a floor if the state pension is insufficient to live on
  - At the end of 2023, ∼**690,000 pensioners** relied on this benefit
- **The Economic Incentive Problem:**
  - For low-income workers, private savings (Pillar 3) can be offset by reductions in means-tested benefits, creating a 100% marginal tax rate on those savings and discouraging private provision

Rentenpaket II: Politics Overrules Economics

- **The "Double Stop Line" (Doppelte Haltelinie):**
  - A political promise: Keep the replacement rate $\geq 48\%$ AND the contribution rate $\leq 20\%$
- **The New Deal (Rentenpaket II):**
  - This package is the subject of intense current political and economic debate
  - Permanently guarantees the 48% level until 2031
  - **The Cost:** This deactivates the Sustainability Factor, removing the automatic brake on spending
  - **The Consequence:** The fiscal burden is shifted entirely to the federal budget via massive tax subsidies (*Bundeszuschuss*)



Paradigm Shift? The *Generationenkapital*

Concept: Create a Sovereign Wealth Fund to help subsidize the pension system

- **Mechanism: "Debt-Financed Arbitrage"**
  - The state borrows money at low interest rates (cost of government bonds)
  - It invests this money in a globally diversified portfolio of stocks (aiming for higher equity returns)
  - The goal is to profit from the spread: $r_{\text{equity}} > r_{\text{bond}}$
- **Target:** €200bn fund by the mid-2030s
- **Advanced Risk Analysis:**
  - **Too Small:** Experts argue it needs more than €1 Trillion to have a meaningful impact on contribution rates
  - **Governance Risks:** Can investment decisions remain free from political interference?
  - **Systematic Risk Exposure:** A market crash during a recession creates a pro-cyclical fiscal liability, as the fund and tax revenues fall simultaneously
  - **Governance & Time Inconsistency:** Can a government resist the political temptation to alter investment strategy for short-term goals, compromising long-term returns?

Problems remain

- **Fiscal Crowding Out:**
  - Pension subsidies already consume ∼20% of the entire German federal budget
  - This severely limits fiscal space for infrastructure, defense, digitalization, and education
- **The "Boomer Voter" Effect:**
  - The large voting bloc of the elderly creates strong political resistance to actuarially necessary cuts (Median Voter Theorem)
- **The Reform Challenge:**
  - The German government now wants to create a *Rentenkommission* to find a compromise in the pension problem
  - Supposedly no constraints on potential solutions
  - **The Reality:** It is hard to reform pension systems in demographically changing countries due to political resistance, path dependency, and the long-term nature of pension commitments

Conclusion

Summary:

- Germany's PAYG system is efficient in its design but fundamentally vulnerable to its own demographic decline
- Recent reforms (*Rentenpaket II*) have prioritized short-term benefit security for current pensioners over long-term fiscal sustainability, effectively passing the bill to future generations

The Outlook:

- The *Generationenkapital* is a historic step towards capital funding, but it is too small to solve the structural problem
- The "Contract between Generations" is being rewritten, with the young bearing the demographic and fiscal risk

The final question remains: Who is paying for the pension system?

References

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- ENIREF European Network for Research on Economic Policy (eniref.org)
- Pensionfriend.de
- *Note: Comparisons to Swiss and Japanese systems drawn from course materials*