

Policy Brief

Germany: Pension Policies for an Aging Society

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SUMMARY

Germany has a dwindling labor force as a result of low fertility rate and at the same time high expectancy rate. The working age population is decreasing and the 65 plus years population or pensioners are rising. This signifies that, the number of the contributors to the pay-as-you-go pension system will be less than the pension recipients. Therefore, the pension fund will be inadequate and can cover its expenses for less than a year in the long run. Henceforth, there is the pressing need of significant reforms in German pension systems. The Federal Government of Germany has initiated different policies to stabilize the pension fund with the recent one being the increment in retirement age from 65 to 67 years by 2029. The objective of this supposed policy was expected to decrease the number of the pensioners and increase the number of contributors to the Pension Fund. However, this recent policy has still not been able to entirely address the Pension Fund Coverage decline. The data indicates that the average retirement age is normally below the standard retirement age. Hence, this current policy has not been feasible enough to meet the goal. Since the fertility rate is inadequate to feed into the Population group of 15 to 64 years, the suggested policy here tends to increase this population group and consequently the labor force by injection of immigrant labor force. Literature shows that, Germany needs to offset labor shortages by immigrant labor force in various fields. The inclusion of immigrant in the labor force do not only fill the gap but might also help to improve average productivity in the economy, most especially with the addition of the skilled immigrants. This will intend increase labor force and hence a rise in contribution to the pension fund.

PROBLEM

The first formal pension system to be introduce to the world was the German pension system which was formulated by Bismarck almost 120 years ago (Berkel & Börsch-Supan, 2004). In recent years, the system has played a significant role in ensuring a sustainable retirement income at fair contribution rates. It has survived two major wars, the Great Depression, and most recently, unification. It has been considered as one of the reasons for social and political stability in Germany.

The pay-as-you-go pension system being practiced in Germany are contributions paid by employers and employees are used to fund pensioners. The calculation of the pension benefit is based on the number of pension points earned throughout the working career. In addition to the

pension tax revenues, the system is also funded by the government subsidies. Nearly all workers in Germany contribute to the Social Security Retirement Program. Majority of workers receive almost all their retirement income from this public retirement insurance. Germany pension system is now facing severe challenges because it now experiences the most dramatic population aging among the industrialized countries which currently endangers the social security system in its generous shape.

This aging population can lead to consequences such as population decrease, labor force reduction, productivity decrease and decline in rates of return and living standards. This will in the long run affect the whole economy.

Relatively low fertility rates in combination with decreasing mortality rates and a continuous growth of life expectancy have resulted in this strong demographic aging. As a result, the number of retirees increases and at the same time the working population who are contributors to the pension fund decreases. Subsequently, the pension fund will be insufficient, and the pension fund coverage of beneficiaries will be less than one year.

Despite substantial public spending on family-related transfers, Germany has low fertility rate compared internationally, and most analysts do not expect a significant increase over the current rate of 1.6 in the near future (Höhn et al, 2008).

In a nutshell, Germany must expect a change where more and more old people are supported by fewer and fewer young individuals. This jeopardizes the financial sustainability of the unfunded pension systems which rely on a reasonable aged dependency ratio. Therefore, if recent trends continue it will cause massive disturbance in Germany socio-economic system. This leads to vast amount of pension fund deficit which means the request for more government subsidies. Hence an increase in the burden on the Government budget.

POLICY OPTIONS

Making the pension fund more sustainable has always been on the government's policy program, but now it has gained more priority than ever before. Germany has been more concerned about its aging challenge in the recent past. This section consists of some important examples of these policy measures which were intended to stabilize the demographic structure.

The government has introduced some policy reforms between 2001 and 2004 for curbing the impact of the population age structure to enhance long-term sustainability of the pension fund. Despite these policy attempt, the financial sustainability of the pension systems and retirement income adequacy remained the same. In 2007, the German government implemented a policy measure to increase normal pension age gradually from 65 to 67. This policy started from 2012 and ends at 2029. The relatively long transition period is meant to adjust the working condition of the older work-force in demographical terms. Now people can retire at two statutory ages in Germany which are the normal retirement age and the early retirement age. For persons with an insurance record of at least 35 years, early retirement is possible at the age of 63. However, the pension benefit will be reduced by a permanent deduction of 0.3 % for each month an employee leaves earlier than the statutory retirement age.

The entire economy and specifically the pension system will gain by increasing the retirement age. However, the tendency toward early retirement by workers can hinder the success of this policy since they generally prefer a lower retirement age. Furthermore, increasing retirement age policies can reduce employment probabilities of younger workers. In addition, older workers appear weak substitutes for younger ones. The number of the pensioners will increase within the next two decades even with the increase of the statutory retirement age.

Germany government also has introduced some family policies to address the birth rate decrease. Though these policies had only short-term effects on increasing the population fertility rate. At first, the birth rate started to increase a little from 2007 then came back to lower level in the following years.

Another policy measure which help to support the pension fund is increasing the labor productivity. To compensate the decrease in the total number of workers, production per worker needs to increase to 18.5 percent until 2035. It means an additional productivity gain of around 0.7 percent is needed. This policy measure is unlikely to be feasible because this amount of increase in labor productivity is clearly appears out of reach in a high-productivity country like Germany (Bonin,).

Increasing the female labor force participation rate is another policy measure which would eventually lead to growth in the work force and can help the pension system sustain for a longer time. Germany still lags behind advanced countries like Denmark, Finland, Norway, and Sweden

in terms of women participation in the labor force. Implementing this policy measure can help to increase average family income which motivates families to have more kids. Although current tax and social welfare legislation are in favor of male workers and need to be revised to make this policy feasible. Also, family policies such as available and cost-effective external child care and more child care benefits would enable women to combine work and family life. However, demographers believe that women involvement in workforce can have adverse effect on the fertility rate because women tend to focus on their career at the expense of raising a child.

RECOMMENDATIONS

The policy tool recommended for sustaining the pension fund system is rising the pension tax revenues by allowing more skilled workers immigration flow into the labor force productive age. This will intend intensify the number of workers and subsequently the pension fund contributions and tax groups of the country. These immigrants labor force fills in the employment gaps at where the German employers fall short of demand. Controlled managed labor migration is a vital policy to meet labor demands. This will stabilize the age structure by increasing the fertility rate and the working age population respectively. This will further reduce the aged dependency ratio. Therefore, the integration of the immigrant population into the labor force is very essential. However, the efficacy of migration as a tool towards preventing aging population and making the pension fund more sustainable relies on the national government ability to effect appropriate immigration policies (Coleman 2008).

In the 1960s and 70s Germany experienced a high number of intentional immigrants. This was a result of a political agreement due to an urgent need of labor force. Recently, the unsustainable pension fund due to the structural change in Germany has led to a situation where new employees are needed again. The pension fund coverage (the time length that the pension fund can fund the pension benefits) is decreasing which make both the retirees and government concern about the future. More pension fund deficit means more required government subsidies which a burden on the government will be. For designing the policy, at first a pension fund coverage should be set. Then, the desired pension fund is defined based on the present pension benefit rate to achieve the pension fund goal. Increasing the number of pensioners causes higher desired pension fund. For having the desired pension fund goal, we can increase the pension tax revenue or income to the pension fund. Having more pension tax revenue needs more contributions or higher number of the

total workers that can be called desired number of the total workers. The total workers are supplied by the labor force and desired number of the total workers is possible just when we have desired number of the labor force. Due to the low fertility rate, the native labor force is decreasing and cannot reach to the desired numbers. The immigration policy recommends providing desired number of the labor force by skilled workers immigrants who are added to the native labor force.

Therefore, in summary, more pensioners mean more pension benefits and higher pension fund goal. Moving this goal to the higher numbers means higher required immigrants which in the long term become pensioners and causing more pensioners again. Therefore, a reinforcing loop can be detected here. More pensioners lead to more immigration and more immigration causes more pensioners after some years. For making the recommended policy applicable and preventing this reinforcing to ruin the policy, it is recommended that the resulted pensioners from aging of the skilled workers receive their pension benefits from sources different from pension fund. It prevents the continues growth in the number of the pensioners and the pension fund goal will be increase reasonable and the desired number of the immigrants will not increase exponentially.

The skilled workers immigrants pay pension tax during their working life and the economy will be improved significantly after their entering. Therefore, it is reasonable that the government afford the pension benefits of this group which is just a small portion of the GDP. Also, the non-governmental or voluntary sources can also afford this group of the pensioners.

In order to implement this policy measure, based on the estimated labor force gap and the available job vacancies, a definite number of labor force immigrants will be given permit to work in Germany. Germany has been a country for the immigrants. For instance, in the year 2000, about 20, 000 special permits were issued under a pilot program attracting workers in the technological space. Additionally, a blue-ribbon commission suggested enlarging the program to 50, 000 permits in July 2001. Subsequently, in June 2002, the government approved a new law which sought to accept potential immigrants based on age, education and skills on a ranking scale. Nonetheless, the number of unfilled job positions attained a record high of 1.2 million in the last quarter of 2017 (OECD, 2017). Likewise, this necessity was repeated in the 2018 coalition agreement, signifying that Germany needs new labor force migrants.

Clearly, the skilled workers immigrants are fertile, and their next generation will come to exit after some years. Therefore, the population increase resulted from the immigration is not just limited to

the skilled workers themselves but also their next generation should be considered. It shows that the immigration policy should be implemented completely under control and it is just a short-term policy. Because non-managed and long-term immigration can cause a change in the demography to have a very large portion of the immigrants which is not favorite with the people and politician.

An aspect of the implementation of this policy measure is by increasing the number of international students and stimulating their retention in the German labor market. This can compensate for substantial part of the skilled labor shortages. For instance, the number of international students in Germany has been gradually increasing in the preceding years. In the winter semester of 2016 and 2017 academic year, about 265 000 international students were enrolled in German universities. However, the share of international students in Germany (7 %) is still just below the OECD average which is 8% (OECD, 2017).

Previously, retention rates have been low, that is around 20% of foreign students stayed in Germany after graduation. Notwithstanding the availability of job search visas for graduates and an exclusion from the labor markets test (OECD, 2013). Therefore, creating internships opportunities for international students and making more incentives for them to learn German during their degree can help to make an enhance connection with employers and augment retention rates after graduation.

It must be noted that, the immigration strategy like any other policy tool has some shortfalls. Germany has a relatively liberal legal framework in place for hiring highly skilled migrants, but in practice employers often find the system too cumbersome. As a result, the share of labor migrants to Germany from outside the EU has remained low (OECD, 2017). Again, the German labor migration system is more open to recruiting highly-educated immigrants with tertiary degrees than low to medium skilled ones in spite of the huge skill shortages in medium skilled jobs (OECD, 2013). Employers, and especially owners of small and medium enterprises, should be supported in using the labor migration system. Also, making the process more transparent can this part of the policy measure more feasible.

Furthermore, language skills is a key obstacle for recruiting immigrant workers by employers. Thus, creating opportunities for the labor force immigrants to prove German language skills or even learn German abroad can help to eliminate the language barriers. Younger and educated immigrants can support aging Germany to grow and flourish. Most studies indicated that, the

economy get immense large net benefits from immigration offers. Most importantly, when the contributions of immigrant's children and grandchildren are taken into account.

Germany may have to accustom itself to a more heterogeneous self-image or choose the risk of the economic decrease. Cultural assimilation, moreover, depends on the good will of natives and newcomers alike. The level to which immigrants are ready and able to integrate into the receiving population seems to be a critical factor for the success of immigration strategies (Jonathan Grant, Stijn Hoorens et al. 2004).

It is important to address that the immigration policy is one of many factors to help Germanys pension system to succeed. One should also invest and consider other policies such as promoting lifelong learning, improving active labor market policies and investing in vocational education are also fundamental to address skill shortages in the long run.

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