Stefanie Wahl

Sustainability of Social Systems and Inter-Generation Contract: How to finance Demographic change

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1. Sustainability of Social Security Systems and Justice between Generations - general remarks

Let me start with a parable of Johann Peter Hebel, which he wrote around the middle of the 19th century:

A wanderer comes to pass a peasant, who carries three loafs of bread on a tray. He asks the peasant: "Why did you bake three breads although you can eat only one?" The peasant answers: "You are right. My wife and I can only eat one. The second loaf is for my old parents, who live in the little cottage over there. They brought me up and handed the farm over to me. For this I return thanks." "And the third loaf?" "The third loaf is for my children, that they look after me, when I am old and live in the little cottage over there."

What can we learn from this parable? The active generation always has to bake three loafs. There is no other way to organize a social security system regardless how it works in detail.

There are two principals involved in this parable:

- the principle of care / direct transfers to the parents, that is to the former active generation and
- investment in the future generation.

In modern times the first principal is realized by mandatory systems, organized on a pay-as-you-go (p.a.y.g) basis by the state.

The second principal: the investment in the future can be organized in two ways, which can be combined:

- investment in human capital
- investment in real capital: in the economy, schools, universities, infrastructure etc., to enable the following generation to take care of their parents, when they are old.

Consequently future investment means:

- Children
- Private provision.

IWG BONN
Institut für Wirtschaft und Gesellschaft Bonn e.V. ◆ Wissenschaftszentrum ◆ Ahrstraße 45 ◆ 53175 Bonn
Telefon (0228) 37 20 44/45 ◆ Telefax (0228) 37 58 69 ◆ Konto: Postbank Köln 297189-509 (BLZ 370 100 50)
Internet: www.iwg-bonn.de E-Mail: kontakt@iwg-bonn.de

2. Sustainability of social security systems and justice between generations in Germany - demonstrated by the development of the old age security system

Before industrialization until the middle of the 19th century social security consisted nearly exclusively of private transfers. It was provided by the family, the neighbourhood, private charity and few forms of communal welfare. The precondition that this system functioned was, that the number of non-active persons - that means the aged - was small, the community large enough and the social pressure to provide for the aged high.

During the industrialization life expectancy rose and with it the number of aged. Simultaneously a growing number of persons was disabled and therefore unemployable. At the same time the traditional social structures broke apart. Consequently poverty among old population rose.

At the end of the 19th century the state therefore introduced a mandatory pension system. (Bismarck)

Logically this system was a combination of welfare and investment in the future. With the contributions of the employed a capital stock was built up. The state contributed in form of a tax financed subsidy on a p.a.y.g. basis.

For the next sixty years until the 1950ties this system had to cope with two big wars, one big inflation (1923/24), a currency reform (1948) and a state, that plundered the capital funds. Consequently the capital stock was never fully built up. To finance its wars the state helped itself out of the capital stock.

Thus the disadvantages of a public respectively state funded pension system became obvious:

- It is open to manipulation by the state and
- by managing the capital funds the state obtains a growing and harmful influence on the economy.

Therefore in 1957 a new pension system was introduced, that covered nearly 90 % of the working population and provided about 70 % of former net income (replacement rate). It was financed through payroll-tax and completely organized on a p.a.y.g. basis.

This seemed sensible since the former capital stock was destroyed, millions of refugees had to be integrated and the birth rate was high (total fertility rate (TFR) 2,3, net reproduction rate (NRR) 1,1). Future investment therefore seemed guaranteed.

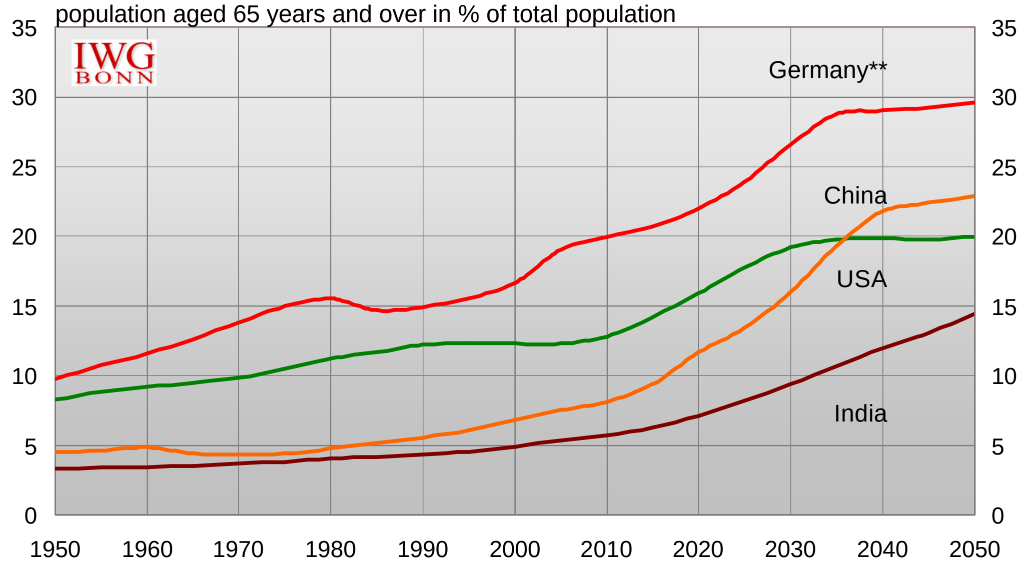
60 years later we know, that the full concentration on a p.a.y.g. system and therefore on public transfer/welfare and the neglect of future investment was wrong:

- The total fertility rate fell below reproduction level (2,1) and is now at 1,3 children per woman

- The saving rate of private households, although it has risen during the last three years to 11 % of disposable income, is too low - given the fact, that the baby boomers (cohorts 1950/70 especially 1960/70) have entered an age, where saving should take place.

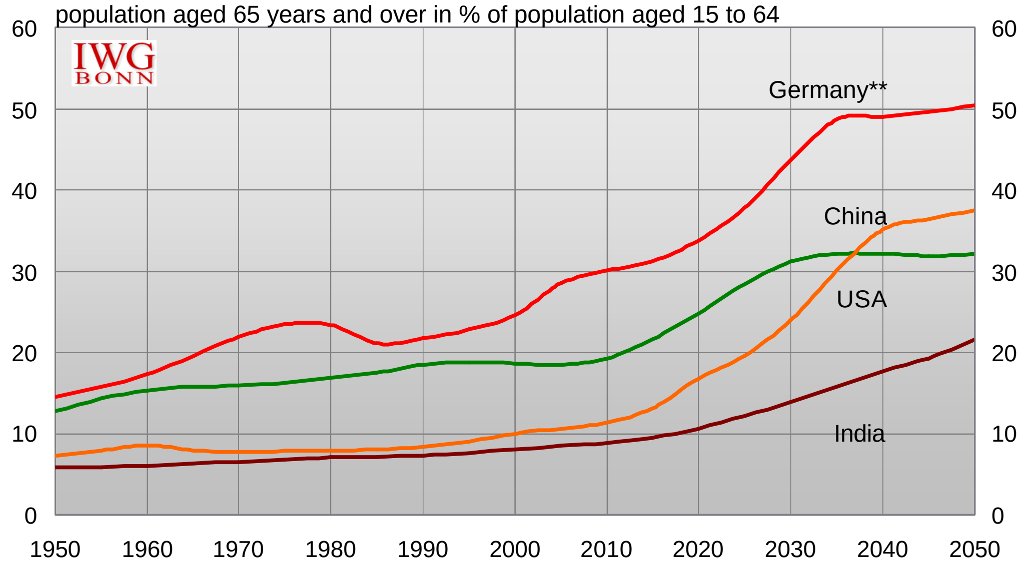
With this concentration on p.a.y.g. and consequently on consumption here and now, Germany is poorly prepared for the demographic change.

Proportion of Old-Age Population in Selected Countries 1950-2050*



*Estimation of the UN-Population Division 2004 (Medium Variant), **Estimation of StaBA (Federal Statistical Office) (Medium Variant)
Sources: UN, StaBA, Calculations of IWG BONN

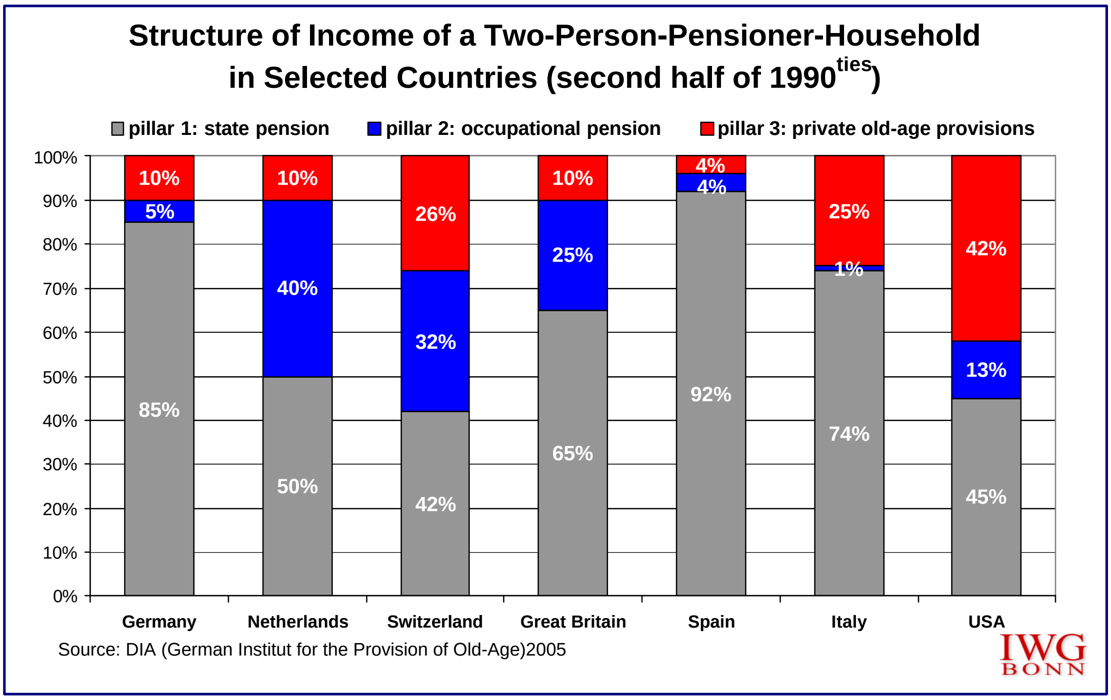
Old age Dependency Ratio in Selected Countries 1950-2050*

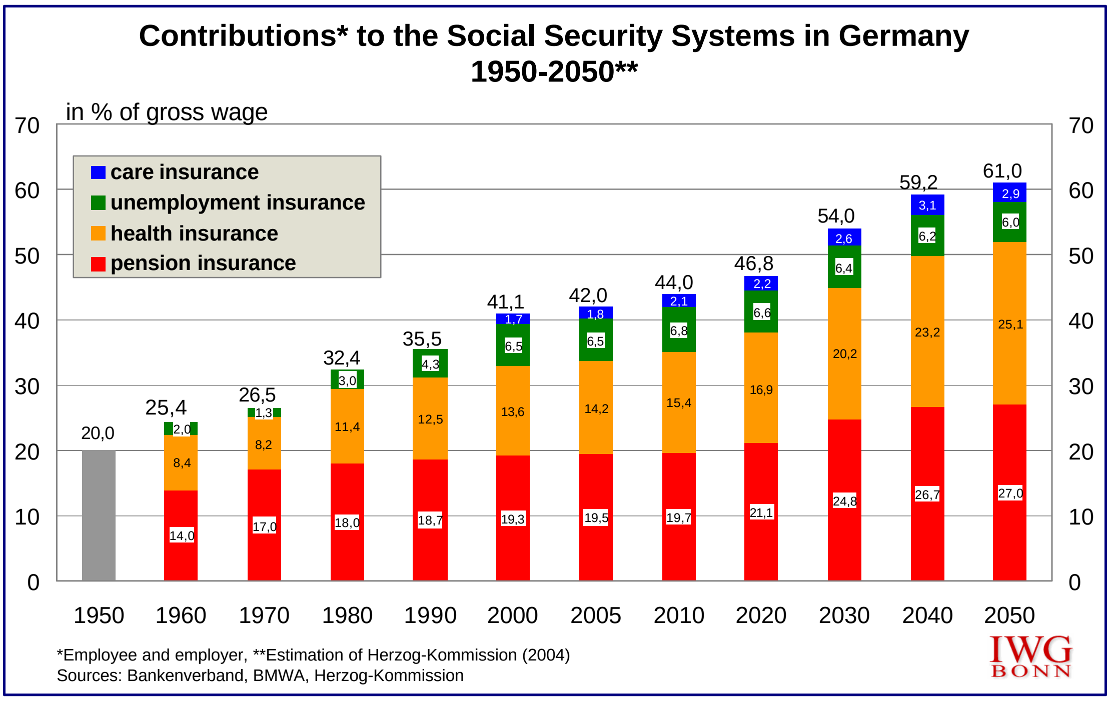


*Estimation of the UN-Population Division 2004 (Medium Variant), **Estimation of StaBA (Federal Statistical Office) (Medium Variant)
Sources: UN, StaBA, Calculations of IWG BONN

Today nearly one fifth of the population is older than 64 years. Until 2050 this proportion will rise by 58 % to 30 % of the population. The ageing process becomes even more apparent if the population over 64 is compared to the active population between 15 and 64 years and the so called old-age dependency ratio is calculated. This ratio increases even by 76 % from 29 % in 2005 to 51 % in 2050.

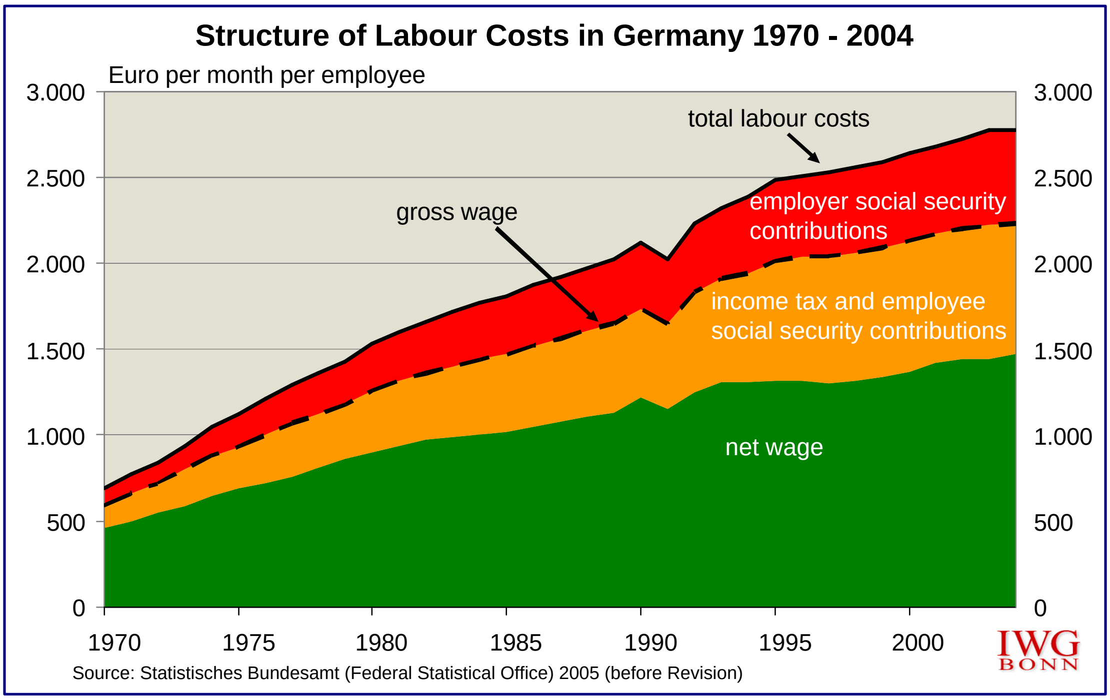
In Germany today in average about 80 % of the income of the former working population is covered by the state pension (pay as you go), 5 % by occupational schemes (most of them capital funded) and 15 % by private provision (capital funded). (The figures of the graph below date from the mid-1990ties when the proportion of the state pension was even bigger.)





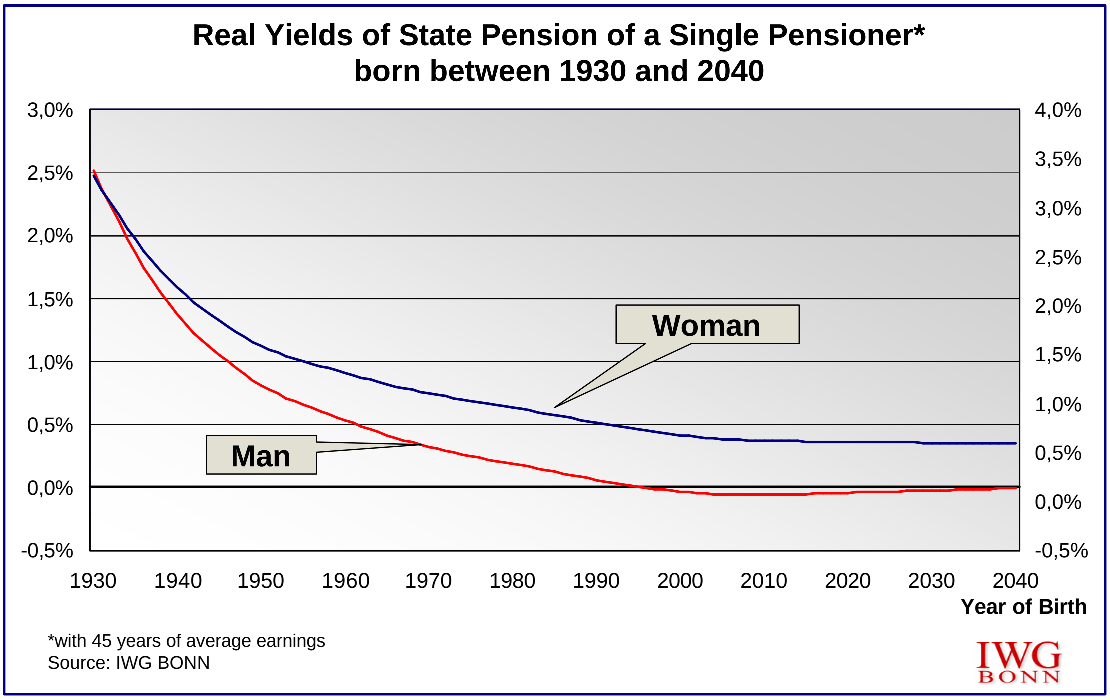
Given the German structure of the old-age social security system the ageing of the population has a lot of negative consequences:

- It leads to growing costs for the active generation.
- As the German pension system is mainly financed through payroll-tax, labour costs rise continuously. This leads to unemployment and stagnating respectively decreasing real net wages.



To limit the increase of social contributions, benefits have been cut back. This results in a continuous deterioration of the relation of social contributions and benefits, respectively of the rate of return of German state pensions.

In other words: Justice between generations is hurt.



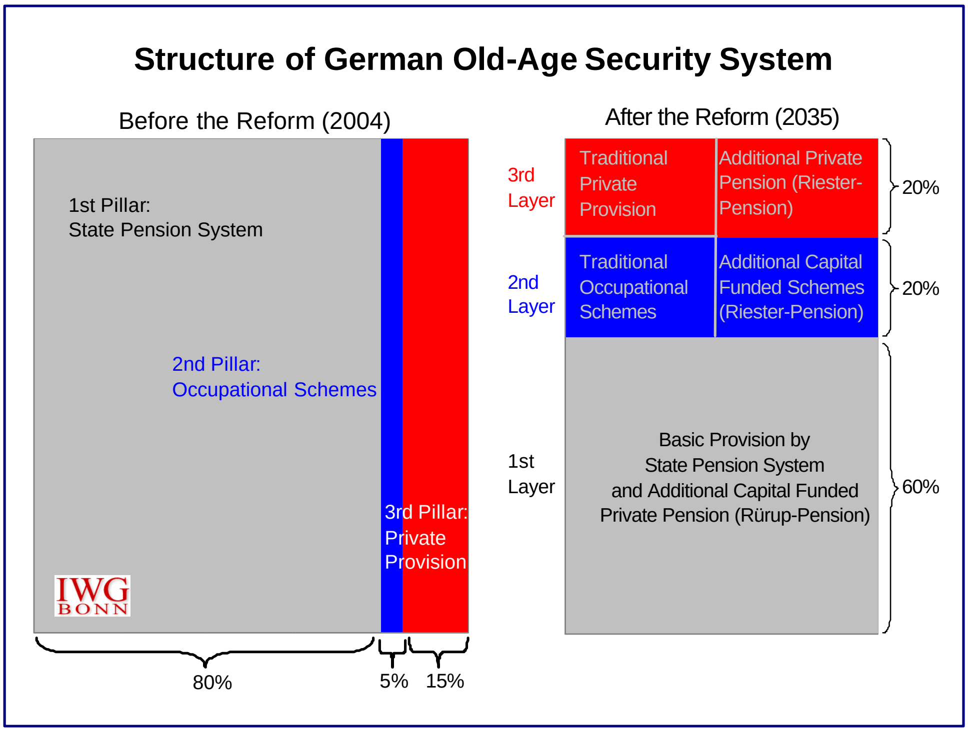
The younger the employee - the higher the burden of the demographic change he has to carry.

Around the Year 2000 the German political class finally realized that the social security system had to be reorganized, if Germany wanted to avoid, that in thirty or forty years time the active generation leaves the system. With good reason they can say: It is not our fault, it is your responsibility that you are so many and we are so few.

There are two main measures that lately have been undertaken by the German government:

- By reducing the level of state pension and subsidizing new forms of private provision, the mix of p.a.y.g. and capital funded elements will be changed and future investment increased.
- By raising pension age, the increase of the non-active population will be less steep.

Instead of drawing 80 % of old-age income from the state pension scheme, 5 % from occupational scheme and 15 % from private provision, in the 2035 the mix should be as follows: 60/20/20 and in the year 2050: 50/20/30.



Instead of pillars the German old-age security system now consists of three layers.

- First layer: basic provision, that consists of the reduced state pension (p.a.y.g.) and a new private capital funded basic pension (Rürup-Pension) especially for self-employed.

  Each grants a life long monthly pension, when a certain pension age is reached. The entitlements of both forms are not eligible as collateral, not disposable, not transferable, not devisable (state widowers pension is being substantially reduced) and can't be capitalized.

The private basic pension consists of a private life-annuity. This private pension is tax deductible. It is therefore especially attractive for self-employed aged 55 and over with a high tax burden.

- The second layer is exclusively for the employed population. It consists of traditional occupational schemes, that are with one exception (employer's pension commitment) capital funded and of additional capital funded forms, that can receive substantial direct state subsidies or tax deduction, which ever is more favourable, if they fulfil certain criteria (not eligible as collateral, not transferable, not devisable).

  This private pension (4 % of gross earnings) also has to guarantee lifelong monthly pensions, although 30 % can be drawn at the age of sixty. The Riester-Pension is especially attractive for average and low earners and families with many children, as there are special subsidies for each child. However there are quite a lot of limitations, such as that the state subsidy has to be returned, if the pensioner leaves Germany and lives abroad.

- The third layer consists of all forms of private provision like stocks, real estate, life insurance etc. and the Riester Pension.

How is the tax regulation? With the exception of the traditional private provision taxation follows when the pension is drawn, that means taxation is subordinated.

The advantages of the German pension reform are:

- Capital funded elements are strengthend.
  The adaptation to demographic change is improved.

But there are also disadvantages:

- The system is far too complicated.
- The system is too bureaucratic.
- The new private pensions don't favour investment in very productive sectors, where capital is really needed.
- For many employed private provision is still not sufficient to compensate the decrease of state pension.

3. What lessons can be drawn from the German way to cope with the demographic change in the field of old-age security?

- The process has to begin with a sensitisation of the population in regard to demographic change, for instance through more information about demographic change and its consequences.
- Politicians, media and the public have to discuss all options and limits to adapt to demographic change.
- Risk and chances have to be identified and communicated to the public.

- Especially politicians have to act early enough!
  The earlier a country reacts, the more options it has.
  Germany has lost important years to adapt; its demographic window (1980 / 2010) is nearly closed.

- Age and the aged population have to be redefined.
  The criteria should be: competence and capacities and not the number of years. Everybody ages differently. Therefore strict limits of age have to be avoided and instead flexible forms of retirement with deduction respectively extra payment in case of earlier respectively later retirement have to be introduced.

- Collective respectively state elements on p.a.y.g. basis have to be limited to cover basic risks.
  A basic pension for all citizens should be introduced that is tax financed and covers the level of subsistence. In the health sector a tax financed health insurance, that offers a basic coverage should be introduced with the possibility of additional private partly capital funded insurances.

- The formation of private capital funded provision in all branches of social security should be encouraged.
  Private capital funded elements in social security are the best way to accumulate capital, which is the precondition for investment and economic growth. Scarcity of capital is a bottle neck of the Chinese economy. A clever mix between p.a.y.g. and capital funded elements contributes to the accumulation of capital and therefore to economic growth.

- A simple structure and few regulations have to be chosen. (Don't make it complicated.)
  The new German additional private pensions should not be copied.

- How could an optimal Chinese old-age security system be organized?

  40 to 50 % of old age income could come from a basic state pension on p.a.y.g. basis for all citizens financed by taxes. The rest of the income could come out of protected capital funded private provision.

  What is the best protection? A stable currency with no or very little inflation.

IWG BONN - Bonn Institute for Economic and Social Research
Stefanie Wahl
Managing director
Adress: Ahrstraße 45, 53175 Bonn, Germany
Phone: 0049 228 372044
E-Mail: kontakt@iwg-bonn.de
Internet: www.iwg-bonn.de