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The Equity Pension — How It Can Mitigate the Demographic Problem of German Pension Insurance

Demographic change poses major challenges for German pension insurance: if fewer and fewer contributors face more and more pensioners, contribution rates will have to rise or pension benefits will have to fall. If the aim is to avoid both these outcomes, the pension fund will have to be supported from outside. Up to now, this has been done primarily through subsidies from the federal budget – a method that is increasingly reaching its limits. The German government now wants to help stabilize pension finances with what is known as the equity pension.

The equity pension is to work as follows: A certain amount is set aside each year from the federal budget to be invested in shares or other financial assets. The income from the capital saved in this way is earmarked to support the pension fund and limit the increase in pension contributions. The assets are managed by the German Nuclear Waste Management Fund (KENFO). This fund already manages the money set aside for the storage of radioactive waste from decommissioned nuclear power plants.

Compensation for Lost Contributors

What is to be made of this? In principle, it is right to respond to a declining number of contributors to the pay-as-you-go pension insurance system by building up savings capital. If less human capital is available to generate pensions, and if one wants to avoid both declining incomes in old age and rising contributions, another form of capital is needed to fill the gap.

There are different ways to implement this. In principle, one could demand that responsible citizens build up savings themselves. Indeed, the government has encouraged people to save for their old age through the Riester pension program. However, experience with this has been sobering. High administrative costs and legally required guarantees mean that the returns are unattractive. People on low incomes also find it difficult to set a little aside from their tight budgets for old-age provision. When pensions fall, moreover, they have considerable incentives to rely more on the welfare state to supplement their income in old age. If the government builds up these savings, this problem does not arise.

Options for Government Capital Formation

However, even in the case of government capital formation, the question arises as to where the funds should come from. There are three options here. The government can go into debt and invest the money it borrows. It can raise taxes. Or it can cut public spending and divert the funds into the equity pension.

Financing through debt relieves the pension fund only if the investment returns are higher than the interest the government must pay on the loans. Germany is still considered the most solid debtor in the euro zone; interest rates on German government bonds are therefore low. Germany can exploit this advantage with its equity pension.

In the case of equities, a return can be expected in the long term that is noticeably higher than the return on German government bonds. However, for the yield difference to be sufficient to relieve the pension fund noticeably, the government must either take on high debt or save for a very long time. Using the debt-financed concept of the German Citizen Fund, the ifo Institute has shown that an investment of a manageable 0.5% of GDP over the entire period of employment would lead to retirement income of EUR 16,000 in today's prices. Today's young generation could therefore benefit noticeably from a debt-financed equity pension. But it takes time for the income to accrue. And there are fluctuations in share prices that must be endured in the meantime.

Narrow Financing Scope

Savings can be built up faster if financing is provided through higher taxes or lower spending. But this comes at the price of having to do without other things today. The federal government finances the equity pension through the federal budget. It remains open whether there would have been higher government spending, lower taxes, or lower debt without the share pension, even taking into account that the constitutional debt brake would not limit debt financing of the equity pension because the debt would be used to acquire a financial asset.

What happens if the equity pension is not effectively debt financed and tax changes that go beyond the coalition agreement are politically infeasible. The result would then be that policymakers finance the equity pension primarily through reallocations of expenditure. How this is to be assessed depends on which spending is eliminated. If public investment falls, one future provision would crowd out the other.

As far as the management of the funds for the equity pension is concerned, two aspects are crucial. First, it is important to keep administrative costs low. In the case of the Swedish pension fund, AP7, which is often cited as a model, management costs are 0.05% per year. This could be achieved in Germany, too, through cooperation with private fund providers. Second, the fund's investment strategy should not be subject to any political requirements that contradict the goal of providing effective financial support for pensions. If all this works out, the equity pension can help stabilize the pension system.

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