To the point!

Cross-Asset- and Strategy-Research

Germany sleepwalks into a pension squeeze

The ruling coalition is failing on retirement policy

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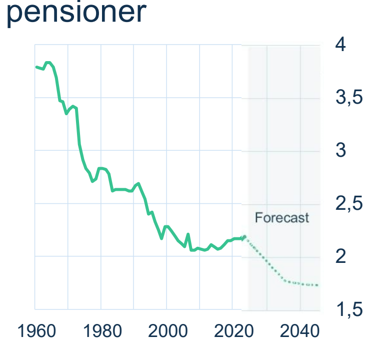
Digging your teeth into tough tasks demands dogged tenacity and resolute leadership. And given Germany's adverse demographics, no task in politics is tougher than retirement policy. The arithmetic is obvious: ever fewer workers and contributors will have to finance ever more retirees (see Fig. 1). Whatever your priors, one thing is clear. No – not that German old chestnut, 'the pension is safe', a 1990s mantra meant to reassure voters about the pay-as-you-go system. What is safe to say is that the German coalition – an alliance of the center-right Christian Democrats (CDU/CSU) of Chancellor Friedrich Merz and the center-left Social Democrats (SPD) – has not covered itself in glory.

Fig. 1: Contributors per pensioner



Source: Destatis, LBBW Research

After a brief flutter of rebellion among younger MPs in the Christian Democrats, rumors of a coalition collapse swirled. That was never likely. Tonight we will know more. The law is being put to a vote in the Bundestag in the coming hours. My own expectation is that the young rebels will collectively vote in a way that would not risk the collapse of the coalition after little more than six months in office. The government parties are polling poorly, and neither has a realistic alternative to muddling through this marriage of convenience. Still, you get the impression that the Merz government saw its honeymoon end even faster than the famously fractious 'traffic-light' coalition, the previous three-party government of Social Democrats (red), Greens (green) and Free Democrats (yellow).

German government parties are polling poorly

Demography as destiny

Germany has been ageing for decades – faster than most advanced economies, and Germans have long known it. The birth rate fell to average 1.5 children per woman since the early

1970s, implying that each cohort is roughly a quarter smaller than its parents' generation. So far, only net immigration has prevented outright shrinkage. Despite this demographic headwind, the contribution rate to the statutory pension system remained constant for years: at 18.6%, it is the same today as in 1995. Rising numbers of retirees were long offset by growth in employment and real wages, which swelled contributions. Even so, the federal budget's transfer rose steadily and is now the largest single item – a bit over €90bn in 2024. That money financed benefits for those who had paid in little or nothing (including many East Germans before reunification) and plugged various holes.

But pressure is set to rise. Years of weak economic momentum – compounded by demographics – are likely to stall social-insurance employment. More importantly, the large cohorts born in the 1960s are beginning to retire. Burying one's head in the sand will not help.

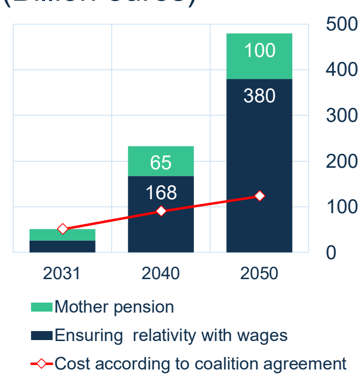
Retirement wave ahead!

Kicking the can down the road is not a plan

The coalition agreement already displayed a curious lack of ambition: "Old-age security will be put on reliable footing for all generations. The replacement rate will be legally safeguarded at 48% [of average wages] until 2031. Any additional spending will be covered from tax revenues." In principle, the so-called sustainability factor – an automatic link between benefits and the ratio of contributors to retirees – should then apply again: when the ratio of contributors to retirees worsens, a quarter of that shift feeds through into diminishing benefit levels. That would, after 2031, trigger a one-off drop in the current 48% "holding line" to below 46% by 2033. In response, the government has put forward a 2025 retirement package – a bundle of pension measures – that aims to block precisely this negative adjustment. Model calculations put the cumulative extra cost at €380bn by 2050. On top of that, the planned expansion of the "mothers' pension" (extra pension credits for child-rearing) could add almost €100bn by 2050 (see Fig. 2). Most of these costs will fall on future governments. Draw your own conclusions.

The costs will fall on future generations

Fig. 2: Cumulative burden for federal budget (Billion euros)



Source: Prognos, LBBW Research

A pension commission, confronted with faits accomplis

The coalition treaty also promised that by mid-term a commission would present recommendations for a sustainable system. Not waiting for those recommendations and instead setting facts now is highly problematic. In such a central area, rushing decisions that may contradict expert advice – and might have to be reversed – would only add to widespread political disenchantment and strengthen the extremist fringes of the political spectrum. This is not how to regain trust in the political system. The governing coalition's retirement package will burden the federal budget for decades and further calcify spending.

Credibility of the political system is on the line

The coalition agreement was titled "Responsibility for Germany." What Germany's getting on pensions is not what it says on the tin.

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