



# Parties not focusing enough on sustainability

Welfare proposals against a backdrop of positive economic development

July 17, 2017

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The debate over welfare policy in Germany appears to be paradoxical. On the one hand, revenues and spending in the welfare systems have never been so high – and both are set to continue to increase sharply. In 2015, welfare spending per capita reached almost EUR 10,900 – some 9% higher than in the UK. Nevertheless, some critics believe that there is a social imbalance.

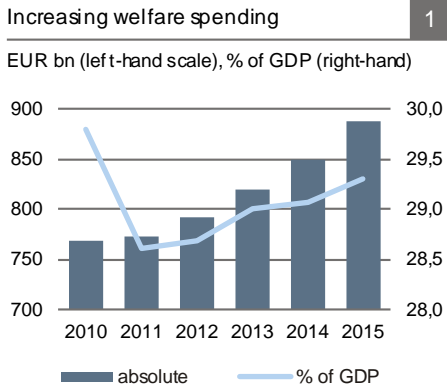
The welfare system is better than its reputation in Germany suggests. Social security continues to have a positive impact. Welfare spending significantly reduces the number of people at risk of poverty (2015: from 25.1% to 16.7%). In particular, there is no reason to interpret the situation facing the elderly as dire. The number of elderly recipients of basic welfare benefits has fallen by 2.5% over the past year. By contrast, single parents and the unemployed are at higher risk of poverty. This shows how important integration into the labour market is to prevent poverty.

The welfare system operates under favourable conditions at the moment. Not only is it benefiting from the positive economic trend, the impact of population ageing is (still) relatively low. The number of over-65s has only increased by roughly 0.2 million on average over the past few years, whereas this figure is expected to grow by double that margin annually over the next decade. This means that rising welfare costs are on the horizon.

However, planning for the future is playing second fiddle to another issue on the campaign trail. Instead, many proposals are based on further expansion of the welfare state, even though the current government has already burdened taxpayers with avoidable costs.

The Social Democrats (SPD) and the Left (Die Linke) in particular want to move away from consolidation of the public pension scheme. A guarantee of the current replacement rate (48% of average income) and stable contribution rates can exist in the scheme only if there are no barriers to long-term economic growth and to labour market flexibility and if government subsidies to the scheme increase further. However, the former does not hold at the moment and would likely be thwarted by the latter.

In terms of healthcare, the Free Democratic Party (FDP) is one of the main proponents of increased competition. The SPD, the Greens and the Left want to merge private and statutory health insurance into a single “citizens’ insurance” system. However, it is doubtful whether this would lead to “greater equality” given the opaque and unmethodical distribution of costs through income-dependent contributions. Provisions are set aside for old age in private health insurances, so long-term sustainability in the healthcare system would be lost in the event of a merger.



Sources: BMAS, Statistisches Bundesamt, Deutsche Bank Research

### Complaints over social imbalance despite rising welfare spending

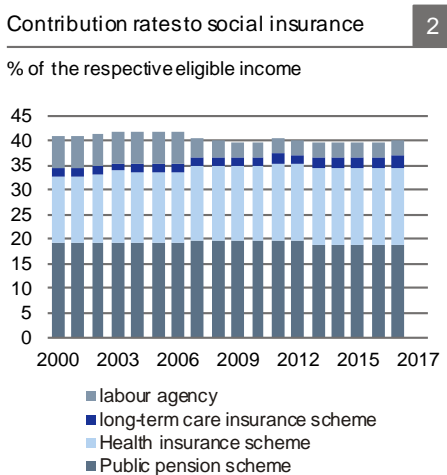
The debate over welfare policy in Germany appears to be paradoxical. On the one hand, revenues and spending in our welfare systems have never been so high. At major institutions, especially the public retirement insurance and statutory health insurance schemes, income (from contributions) as well as spending are breaking record after record. All in all, the 2015 welfare budget (most-recent figures available) reported spending of EUR 888 billion. That equates to EUR 10,874 per capita – roughly 9% higher than the UK but lower than Scandinavia. Nevertheless, some critics believe that there is a social imbalance.

Revenues are blooming due to rapidly growing contributions caused by rising employment and rising wages, but also because welfare contributions have risen by 0.45 percentage points to almost 40% since 2013. In addition, funding provided by the federal government is also increasing. In 2016 it injected EUR 14 bn into the statutory health insurance and EUR 87.5 bn into the public pension scheme.

Welfare spending is also rising sharply. The 2015 welfare budget was some EUR 120 billion or 15.5% higher than in 2010. Even when measured against gross domestic product, welfare spending has risen over the past few years (2015: 29.3% of GDP; 2011: 28.6% of GDP). Healthcare and nursing care spending is increasing particularly sharply, by an average of 4.4% and approximately 8% per year respectively since 2013.

### State driving costs

These figures are particularly surprising given the favourable environment for the welfare system at present. Not only is the system benefiting from the positive economic development, the impact of the ageing of the German population is (still) relatively low. According to the Federal Statistical Office, the number of potential retirees (of the over-65s), has only increased by roughly 0.2 million on average over the past few years, whereas annual growth rates of double this amount are expected over the next decade.



Sources: Bundesversicherungsamt, DRV

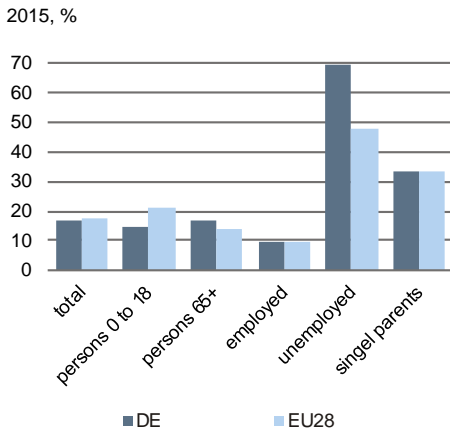
Government policy was one of the major cost drivers in this current legislative period, which is nearing an end. For example, legislators responsible for statutory health insurance passed on some of the financing of government responsibilities, such as investment in securing hospital infrastructure, to contributors. In particular, the pension reforms introduced midway through 2014, including lowering the retirement age to 63 and introducing the so-called mother's pension, are proving to be a long-term burden on the pension system. In 2017 the elimination of early retirement pension deductions for those long-term insured who have retired prematurely (at 63) and higher pensions for mothers with children born before 1992 is likely to cost some EUR 8.25 bn. Politically motivated spending means that the pension scheme has run and is likely to run deficits in 2016 and in 2017 (2016: EUR 2.4 bn; Jan. to May 2017: EUR 2.33 bn). Another issue is that the likely acceleration in the process of demographic change has not been taken into sufficient account in this legislative period, with the sole exception being the recently resolved law to strengthen occupational pensions (Betriebsrentenstärkungsgesetz), which is set to enter into force in early 2018.<sup>1</sup>

<sup>1</sup> This law is aimed at increasing the number of small and medium-sized companies offering company pension plans. Under the new legislation, firms will be permitted to offer occupational pension plans purely as defined contribution plans, without any guaranteed obligations. This will relieve firms of risks and allow pension contributions to be invested in a more yield-oriented manner. In addition, the law enhances legal framework for opt-outs, in other words the automatic inclusion of employees in occupational pension plans, with employees free to revoke their membership and opt out. However, these reforms can only be put through by means of collective agreements. Given the lack of union organisation among SMEs, there are doubts over whether the intended aim of the legislation can be achieved.



At-risk-of-poverty ratio\*

3



\*At risk of poverty = less than 60% of the median equivalent income of the population as a whole

Sources: Eurostat, Statistisches Bundesamt (Destatis)

Social security continues to have a positive impact

The German welfare system is better than its reputation in Germany suggests. Comprehensive social security here continues to have a positive impact, as can be seen by figures documenting people at risk of poverty. These figures measure the share of people whose (equivalent) income is lower than 60% of the median (equivalent) income of the population at large.<sup>2</sup> This ratio is a relative benchmark, which is largely dependent on whether the relevant figure is set at 60% or 50%.<sup>3</sup>

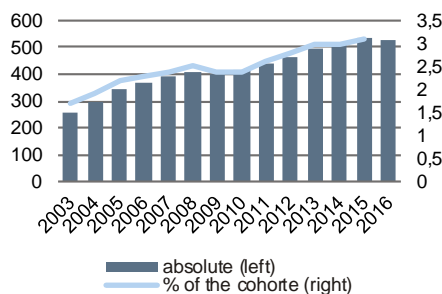
Excluding intervention by the welfare state, the at-risk-of-poverty rate (60%) stood at 25.1% in 2015. Including welfare benefits, the ratio comes to only 16.7% (ratio at 50%: 10.2%). This puts Germany below the average of the 28 EU member states (17.3%).

That being said, this figure has risen slightly over the past few years (2010: 15.6%), likely predominantly due to the increase in earned income. The working populace are the main beneficiaries here, as can be seen by the above-average rise in the proportion of over-65s from 14.1% (but 15.9% in 2008) to 16.5% (EU28: 14.1%). The substantial rises in pensions this year and in 2016 – 6.15% in total in western Germany and as much as 9.54%(!) in eastern Germany – are, of course, also likely to result in a marked decline in the number of elderly people at risk of poverty.

Elderly recipients of basic welfare

4

Year-end, absolute figures in '000 (left-hand scale), % (right-hand scale)



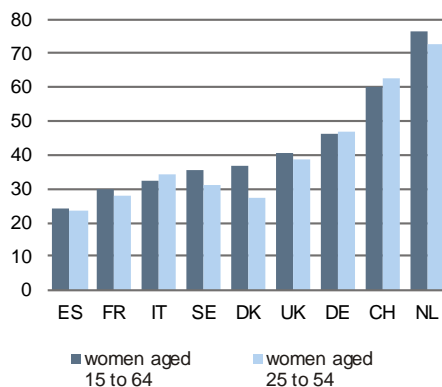
Quellen: Destatis, Deutsche Bank Research

The relatively low number of retirement-age people reliant on welfare benefits, approximately 3%, shows that there is no need to interpret the social situation of the elderly as dire. This figure is even lower, at 2.5%, when only retirees are included in the calculation. In addition, the number of basic welfare benefit recipients at retirement age decreased by 2% year on year in December 2016, which also reflects the pension increase midway through the year.

High percentage of women employed part-time in Germany

5

Percentage of women employed part-time compared to women employed full-time, 2016, %



Source: Eurostat

Increased integration of single parents into the employment market and fewer (long-term) unemployed reduce poverty

Individual groups are, of course, at a greater risk of poverty than others. This particularly applies to single parents (33.7%) and the unemployed (69%). This is a testament to how important employment is in preventing poverty. However, for single parents, raising children often stands in the way of full-time employment. Instead, many single parents – particularly those with younger children – work only part-time. The reintegration of the unemployed into the employment market often fails due to a lack of qualifications. Individuals with no professional qualifications now make up half of the unemployed. The rate of unemployment among unskilled people is almost five times higher (20.3%) than that of skilled individuals (4.2%) This data provides important touchpoints for employment and welfare policy. Key areas here include removing barriers to employment and increasing people's employability.

These issues have since been taken on by politicians. Legislators have long been attempting to enhance the framework for a positive work-life balance including labour market participation, particularly for single parents, with measures such as a legal entitlement to childcare for all children over the age of one (and in kindergartens from the age of 3). This is clearly a complex issue. Childcare is

<sup>2</sup> Equivalent income is not equal to actual income, it is a household-specific; needs-weighted income benchmark

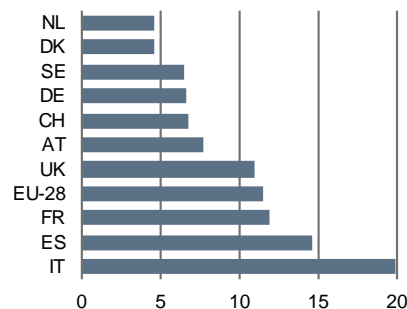
<sup>3</sup> There is justified criticism that even groups such as students, who generate below-average incomes for only a short time period but also have positive outlooks for their professional careers, are included among those at risk of poverty in these statistics. Nevertheless, the ratio is a popular benchmark, particularly in showing the respective groups' potential for social participation.



Positive NEET\* rate in Germany

6

15- to 24-year-olds, 2016, %



\* percentage of young people not in employment, education or training, %

Source: Eurostat

a necessary prerequisite of sufficient employment among single parents, but it is not the be-all and end-all.<sup>4</sup>

Germany has enjoyed a great deal of success when it comes to education and training. At 6.6%, Germany's NEET ratio among young people is one of the lowest in the European Union. The NEET ratio refers to the number of 15- to 24-year-olds not in education, employment or training. Progress has also been made in terms of participation among older people in professional training, which had previously been quite low. In 2014, 37% of 50- to 64-year-olds took part in professional training, up from 30% in 2010. This is primarily due to efforts made by companies in this area.

Education and family policy placed front and centre in election manifesto

Inequality in terms of education opportunities and the relative lack of social mobility are considered two of the German education and welfare systems' weak points. Political parties have responded to this in the election manifestos. Proposals for increased participation in education, particularly pre-school care and education, are usually placed quite highly in these manifestos. The SPD, the Greens and the Left, for instance, are pushing for all education from pre-school level to university to be free of charge. The Greens in particular are focusing on boosting the quality of education institutions. There is broad consensus for the expansion of all-day care and the range of all-day schooling.

The Christian Democratic Union of Germany (CDU) and Christian Social Union (CSU) and the Greens are pushing for improvements to occupational training. Under controversial proposals from the Greens, unemployment insurance is set to play an important role here. The SPD wants to go as far as granting unemployed people a right to training if they are receiving long-term unemployment benefits. Based on previous experiences, this would be costly and not very conducive.<sup>5</sup>

As with education, providing support to families is also given prominence in election manifestos. Besides tax breaks, political parties are offering a number of other measures to help families. These include proposals by the Greens to give more support to parents who want to reduce the number of hours they work, or to help families buy property, which is supported by all of the major parties. In addition, the SPD and the Greens are pushing to give part-time workers a right to return to their full-time employment or rather their original number of working hours (per week). However, this would make companies' personnel planning significantly more difficult and also have a negative impact on other employees. For instance, companies looking to hire employees to compensate for part-time employees could recruit them only on a temporary basis. In addition, both parties would also lack certainty with regard to the length of the new employment relationship.

Debate focusing on basic welfare

Issues such as poverty risk, (long-term) unemployment and promoting employment ultimately concern basic welfare benefits. This is the linchpin of the German welfare system. This particularly applies to basic welfare for persons capable of gainful employment, Arbeitslosengeld II (employment benefit II; ALG II). Basic welfare operates as a safety net in the German welfare state. In economic terms, it can also function as a reservation wage, i.e. a type of minimum wage

<sup>4</sup> Lietzmann, Torsten (2017): More childcare – more integration into the employment market for single parents (Mehr Kinderbetreuung – mehr Arbeitsmarktintegration für Alleinerziehende), presentation, Institute for Employment Research (IAB).

<sup>5</sup> Bräuninger, Dieter (2017): ALG Q and the crux of the equality argument (Arbeitslosengeld Q und die Krux mit der Gerechtigkeit) Deutsche Bank Research. Comment March 2017.

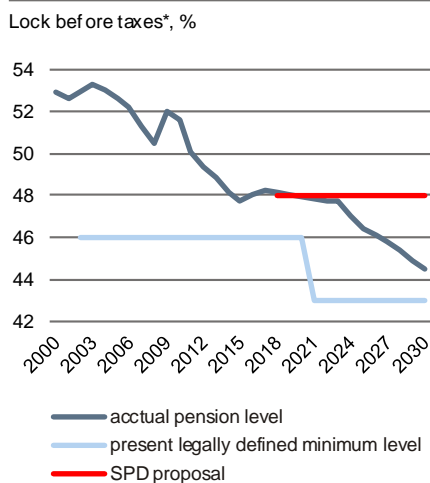


for those entitled to receive the benefit. The recipients, in turn, are obliged to actively engage in returning or integrating into the employment market. At the same time there are also sanctioning mechanisms, so that this obligation does not prove futile. If all this is neglected, there is a risk that ALG II will put up a barrier to employment and not act as a gateway to it.

Nevertheless, the Greens, but also the SPD and in particular the Left, are calling for basic welfare benefits to be much more extensive. The Left, for instance, is calling for ALG II (or Hartz IV as it is also known) to be abolished in favour of a universal basic income of EUR 1,050 per person per month. The Greens also want to stimulate debate over universal basic income. The FDP, on the other hand, wants to reform ALG II. Under their plans, earned income would be offset against unemployment benefit, so that those working part-time or in marginal employment are given an incentive to work more. Future plans would see a citizens' benefit (in the FDP's version a form of negative income tax) replace key welfare benefits.

Falling replacement rate for public pensions

7

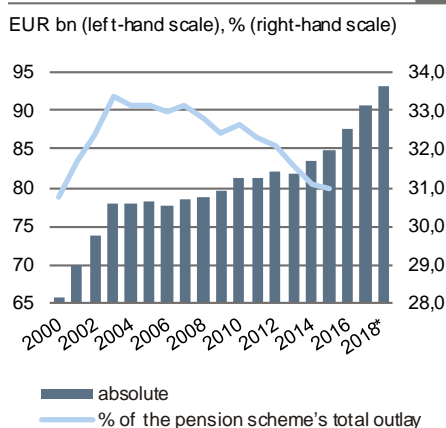


\*Pension entitlement of average earner after 45 years of contribution

Sources: BMAS, SPD

Government funding for public retirement insurance rising

8



\* 2017/18 planned figures according to government budget

Sources: Bundesversicherungsamt, BMF, DRV

### Major social insurance schemes targeted

Even though there are a number of challenges in terms of welfare policy, major social insurance schemes – above all public retirement insurance and statutory health insurance – remain a key issue in this election campaign. Thus, the debate mainly surrounds the bulk of the welfare spending (2016: EUR 528.6 bn – of which EUR 303.7 bn attributed to public pension scheme (including the scheme for miners) and EUR 224.9 bn to statutory health insurance).

### Pensions: SPD and CDU with different priorities

Pension proposals are particularly significant in the SPD's election agenda. Core elements, some of which can also be found in the Greens' agenda, include:

- no further rise in the retirement age
- locking in the scheme's benefit target, i.e. the replacement rate after 45 years of active membership (as employee), at the current rate of 48% of average earned income (after social contributions but before tax). This proposal could cost over EUR 1.3 billion by 2021, i.e. the end of the next legislative period. Costs for this initiative could even rise to over EUR 23 billion p.a. by 2030 (based on current figures).<sup>6</sup>
- locking in the existing limit on future contribution rate increases at a maximum rate of 22% (of basic earnings, currently EUR 6,350 per month for western Germany).
- (temporary) increase in the federal contribution to public retirement insurance
- appreciation of pension claims attributable to long-term insured persons with low incomes (solidarity pension) to a level above basic welfare. (Other parties, such as the AfD, are also calling for this).
- inclusion of self-employed individuals in the public pension scheme.

This political agenda is a volte-face on the reforms introduced by SPD Chancellor Gerhard Schröder in the early 2000s. These reforms were an appropriate response to Germany's ageing population. The trifecta of lowering the level (i.e. replacement rate) of public pensions, raising the retirement age to 67 (until 2030) and the expansion of private, capital-based pensions (i.e. the strengthen-

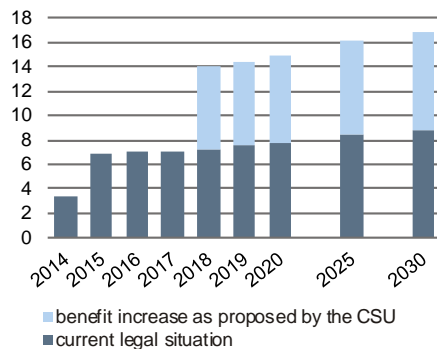
<sup>6</sup> The rule of thumb when it comes to public pensions is that raising the replacement rate by one percentage point would currently cost EUR 6.65 bn (just under 0.5 contribution rate points).



Costs of mothers' pension\*

9

EUR bn



\* Calculations by the Cologne Institute for Economic Research assumed pension increases according to 2016 pension report

Sources: BMAS, IW-Koeln

ing of the occupational pension system and the introduction of the Riester pension scheme) was meant to tackle the decline in the birth rate, rising life expectancy and the upcoming retirement of the “baby boomer” generation. This range of measures will see the negative impact of demographic change be spread fairly across the generations through to 2030, and thus it will offer enhanced prospects for future economic growth.

The SPD believes that it can finance its costly proposals by further boosting employment and increasing productivity. However, the current pension level and stable contribution rates can be guaranteed within the public pension scheme only if state funding is increased. This, by implication, means raising taxes. However, tax hikes are counterproductive if increased economic growth is required. This applies to an even greater extent to the proposals from the Left. They are calling for pensions at a stable replacement rate of 53% – a level last seen in the year 2000.

Unlike the SPD, the CDU does not believe much intervention is required in the public scheme. The party notes that, thanks to previous reforms, revenues and spending trajectories have been fixed until 2030. The CDU only intends to decide on necessary strategies beyond 2030, when the replacement rate is set to fall below the current minimum level of 43%, after the elections. A pension commission is to develop proposals for cross-party consensus by the end of 2019. However, the CSU is calling for an increase to “mothers’ pensions”. This also has funding implications for the scheme, with EUR 6.8 bn required in the first year alone.

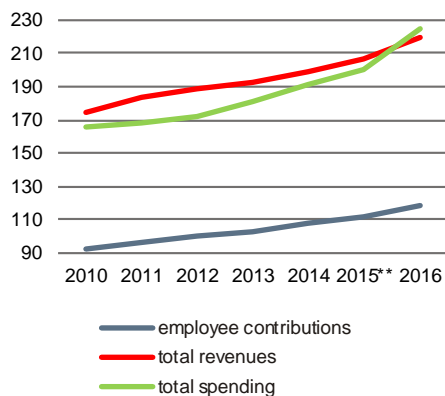
Some parts of the CDU and the Greens, particularly in the federal state of Hesse, want to create new incentives for private pensions. The proposals centre on reforming and supplementing personal pension plans (the Riester pension) with a new pension product without a guaranteed minimum payment. Waiving this requirement for guaranteeing payments would allow providers to invest more in high-yield asset classes, particularly in stocks and shares. This would give potential pension savers substantially improved opportunities when it comes to participating in the growth of the economy, which are few and far between in the current low-interest environment.

### Healthcare policy: reform vs change of system

Income and spending for public retirement insurance

10

EUR bn



\* Health fund, \*\* including additional contributions from 2015

Sources: Federal Social Insurance Office, Federal Statistical Office (Destatis)

Fundamental issues surround the debate on healthcare policy even more than pension discussions. Can major healthcare problems such as providing services to rural areas, ensuring the quality of relevant services and products and, above all, rising costs be solved with the existing institutional arrangements? Is there a need for reform of individual institutions or are completely new structures required?

CDU/CSU, FDP and AfD want to stick with the dual system of statutory health insurance and private health insurance. However, the FDP in particular is pushing for increased competition – both between the two systems and within each system. Under these proposals, citizens should be able to choose between private and statutory health insurance “freely and irrespective of their income”. In addition, it should become easier to switch between private insurers. The FDP also wants to foster competition between statutory health insurers by giving them greater leeway. In addition, the FDP is underlining the role of resident doctors and consultants in ensuring high-quality, nationwide healthcare.

By contrast, the SPD and the Greens, as well as the Left are calling for a completely new system, merging statutory and private health insurance into a universal “citizens’ insurance”. These parties are also pushing for a return to the equal distribution of statutory health insurance contributions between employer and employee. It was, in fact, the SPD/Green coalition headed by Chancellor



Schröder that abandoned this system of parity with a view to boosting employment (the government introduced an additional contribution to be paid by statutory health insurance members only in 2005, with an aim to reduce the costs of employment).

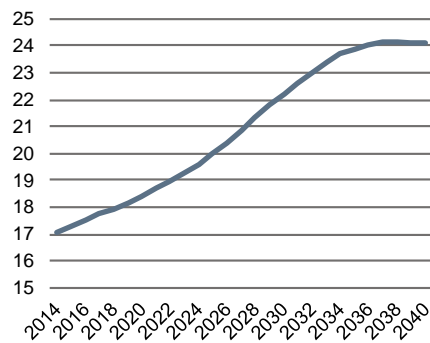
Proponents of this “citizens’ insurance” want to achieve greater equality in terms of access to medical services and the financing of these services. It is considered “unfair” that the privately insured could escape the “solidarity” financing of statutory health insurance. However, these proposals ignore the fact that income-dependent contributions to statutory health insurance result in an opaque and unmethodical distribution of contributions. This issue won’t get much better if contributions are paid on capital gains, too. Such changes would also raise questions concerning the financing of healthcare. Private health insurers and their 8.8 million fully insured members shoulder a disproportionately high percentage of healthcare spending. The above-average income from services for the privately insured and relatively low barriers to offer them innovative new products and services enable providers to invest earlier in the latest technology for diagnosis and treatment. Those insured under statutory health insurance plans also benefit from this investment. In addition, private health insurers set aside provisions for the increased need for healthcare services in old age, and so accumulate capital. In contrast, statutory health insurers are not preparing for the intensified demographic change. Therefore, the citizens’ insurance proposal would mean that the healthcare system would lose its sole element of sustainability.

### Demographics still not high enough on the agenda

Significant rise in population age unavoidable

11

Over-64s (65+)\*, Mio



\* Assumptions: life expectancy for people born in 2060:  
male: 86.7, female: 90.4,  
immigration 200,000 p.a

Source: Federal Statistical Office (Destatis)

As this overview shows, not enough attention is being paid to the demographic challenges facing our welfare system. Instead, many proposals are based on further expansion of the welfare state. But the fundamental restrictions of the system continue to apply. The population is only going to get older. The working age population will continue to decline given the decrease in birth rates observed over the past decades. There is a risk that workers, particularly skilled workers – important high-income contributors to welfare systems – will become increasingly scarce. The high number of immigrants in recent years may be mitigating this effect, but the movement of workers from other EU member states is likely to subside in line with improved economic prospects for the countries in southern Europe. What’s more, the many young people arriving in Germany as asylum-seekers will first have to be integrated into the labour market. This is a major challenge to the labour market and welfare system, too, but political parties are not focusing on this issue to a sufficient extent.

The number of elderly people requiring benefits from the welfare system will increase substantially in the coming decades. The labour force exit of the baby boomer generation from midway through the next decade and the greying of this generation pose huge challenges to the public pension scheme and with some delay to the health care system, too. There is likely to be an increase in spending in both the statutory health insurance and long-term care insurance systems one after the other. Furthermore, the continued rise in life expectancy means that the number of retirees is only going to increase. Immigration obviously does not change this situation. Going by the election manifestos, innovative, sustainable welfare policy that takes these challenges into account can only be expected to a limited extent in the next legislative period.



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