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The End of Berlin's Leadership in Europe? The Fall-out from German Pension Reform

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Germany's coalition government is about the early retirement policy, in an expensive and highly controversial return to the past that may have a negative impact on public finances and the labour market at home, as well as weakening the reform drive in the Eurozone's crisis-hit countries. This could spell the beginning of the end for German leadership of the EU's reform policy. It could also mean bad news for Poland, which prefers a more liberal European economy.

Angela Merkel's government is continuing the social reforms set out in its coalition treaty. After establishing the framework for a minimum wage,[1] the government is eyeing the pension system. In May, the Bundestag is due to pass a reform bill which will come into effect in July. The changes, which, as others before them, carry the distinct imprint of the junior coalition partner Social Democrats, and focus on easier access to allowances, have been the subject of domestic controversy.

Employers' associations already warn that the planned changes would jeopardise pension reforms made over the last decade. And, while ministers from Merkel's Christian Democrat CDU can only grin and bear it, the party's grassroots have been expressing their outrage vocally; he Young Christian Democrats have demanded from their leaders nothing less than suspension of the reform. With the Liberal opposition now adding its critical penny's worth to the debate, Germany has thus become increasingly locked in a heated, inward-looking discussion.

An international perspective was added to the mix when the EU commissioner for economic and monetary affairs, Olli Rehn, voiced his concerns. In an interview with one of the leading German weeklies, *Wirtschaftswoche*, he not only criticised the reform as an inadequate response to Germany's economic and demographic challenges, but added that the changes would put Germany's very financial stability at risk, and Berlin should not be surprised if the European Commission took a sceptical position in recommendations due to published in June under the European semester framework.

"Restoring Justice." Rehn worries above all that Germany is abandoning its own magic formula. The previous governments of Schroeder and Merkel calibrated pensions according to the proportion of the population in work, and those who were pensioners. They stabilised contributions in order to reduce labour costs, and encouraged prospective pensioners to use private insurance systems. In 2006, the retirement age was raised to 67 years. But these are precisely the changes that social affairs minister Andrea Nahles has in her sights. "Restoring justice" is her banner, and she has shifted the focus from financial stability to social need. Pensions will now be raised for parents of children born before 1992 (this segment of the population did not enjoy the financial support introduced later) as well as for people with work-disability allowances.

And yet, Nahles is also planning a change to the pension system of an altogether different calibre, for she will revive the so-called pre-retirement age. People who have 45 "contribution years" behind them will now be permitted to retire at the age of 63 without suffering any reduction in their pension. Since the unemployed are already able to retire two years prior to the regular retirement age, this means that the retirement age will, in some cases, be

[1] See S. Płóciennik, "Politically Demanding, Economically Perilous—Germany Considers Minimum Wages," *PISM Bulletin*, no. 119 (572), 4 November 2013.

reduced to just 61. This reform only increases the incentive to leave the labour market early, in a country where, this year alone, 50,000 people will take up this option. This is an obvious departure from the logic of the Social Democratic reformer Gerhard Schroeder, who effectively closed off these pre-retirement options.

Public Debt and German Leadership. In the initial phase, the increased financial burden is supposed to be borne by a dedicated pensions budget stocked with contributions from employees and employers. But, in 2019, the federal government will introduce annual state subsidies in the range of €400 million to €2 billion. The opposition therefore claims that this will prove the most expensive change to the pension system since the Adenauer reforms of 1957, which increased the level of benefits massively, and sowed the seeds for the system's later financial problems. Experts argue that the sums spent could be better used to reduce the level of contributions and thus labour costs.

But the real problem is that, despite all its commendations for economic prowess, Germany still has a public debt of 80% of GDP, far above the 60% laid down by the EU in the Treaty of Maastricht. In recent years, Berlin has introduced measures to reduce this debt to GDP ratio (not least through the creation of a so-called debt anchor in the constitution), and expected the same approach from other Eurozone countries. These domestic and European reform planks in turn encouraged a new stability consensus within the EU, supported eagerly by Brussels officials such as Rehn. An about-turn from Berlin could thus unravel the European consensus about fiscal self-restraint and supply-side reforms, with countries such as Greece and Italy asking why they should reform if Germany does not.

Demography and Competitiveness. Many German companies, particularly from the *Mittelstand* sector, now see their sophisticated and long-negotiated systems for older employees—their "working time accounts" (flextime systems), flexible employment and additional social insurance— losing its appeal. Worse still, the reform comes at a time of rising wages and skill shortages. Workers in the 60+ category have vast knowledge, hardly replaceable by newcomers, and are now being given an incentive to end their careers. Of course, the government argues that the new rule is limited to a narrow group with 45 contribution years and will not have a massive impact. But it has created a precedent, and all the uncertainty which that entails. It has also angered younger workers who guess that their contributions and taxes will rise, and now complain about a gerontocracy.

This too has implications for the EU. The whole of Europe needs the 60-plus segment to be active on the labour market for as long as possible. The alternative is a collapse of social insurance systems and economic decay. The main alternative, mass immigration, could only partly mitigate the process, and is likely to bring political and economic problems of its own. Until now, however, Germany had led the way. In the last decade, the country was able to increase the employment rate of ageing workers thanks to tax relief and flexible employment. The system was just beginning to work, with employment rates in the pre-retirement age soaring from 39.9% in 2003 to 63.5% in 2013. Unfortunately, the Nahles' reform sets incentives in an opposite direction.

German Reform Leadership in Question. In recent years, many European countries have faced up to the fact that the EU needs its largest members to show leadership. At a time of fierce competition from new rising powers, and of technological change, Germany was a natural candidate. Indeed, even France was beginning to appropriate Schroeder-style social and labour market reforms. The latest pension reform will throw this into question. Germany is expected to invest in its weak infrastructure and education systems, not in old-fashioned, passive social policies. One or two similarly retrograde reforms may not just revive the debate about the "sick man" at the heart of the continent. They may also prove contagious, affecting European societies that are tired of austerity and would welcome more social protection.

Poland, which has, in the past shared German approaches to macroeconomic stability and labour market deregulation, should resist the temptation to follow its neighbour. The employment rate amongst Poland's 55+ demographic sits at just 40.6%, compared to an EU-wide average of 50.1%. The last thing the country needs is a return to the early retirement measures and disability pensions popular in the 1990s. Nor should it risk the already shaky political consensus about the pension age (67). The only positive effect of the German reform can be a side effect, that younger German pensioners with dozens of euro more in their pockets could spend them on their holidays abroad. But in the longer-term perspective, it may see a more indebted Germany exporting its weaknesses to Europe. For all these reasons, Poland should be receptive to Rehn's scepticism on the matter.

But Warsaw's concerns may reach further. For years, Poland has been hoping to form a liberal alliance in economic policy with the UK and Germany, able to suppress the interventionist tendencies of France and the southern EU Member States. For Poland, as for other post-communist economies, unlimited access to markets is crucial for competitive advantage. With the government in Berlin withdrawing from its market-oriented reforms, and possibly more willing to experiment with regulation, this alliance may well become just a would-be option.