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**Working Paper**

## Family, social security and social insurance: General remarks and the present discussion in Germany as a case study

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**Winfried Schmähl**

**Family, Social Security and Social  
Insurance  
– General Remarks and the Present  
Discussion in Germany as a Case Study –**

ZeS-Arbeitspapier Nr. 10/03

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## **Summary**

The paper starts by outlining various links between family activities and social security as well as main arguments for family policy and its design in particular when realised by social security schemes. In the second part, the situation in Germany is presented as a case study illustrating major instruments already implemented and topics under discussion for improving the situation of families by means of social security. It is discussed in particular whether raising children is like a contribution in kind in social insurance, especially in pension insurance, and how to reduce the contribution burden of families within social insurance schemes as an element of a strategy to improve human capital formation.

## 1. Introduction

The links between activities of the family and social security have changed over time, especially in the process of industrialisation, when formal social security schemes were introduced. Today there are many important interactions between families and social security which gain a lot of attention because of demographic ageing in industrialised countries resulting from low fertility and increasing life expectancy as well as in periods of increasing costs in formal social security schemes. The problems as well as objectives and instruments, however, differ depending on the economic, demographic and social conditions of a country. The following remarks are focused on highly industrialised countries with an ageing population.

The paper starts with some more general remarks on the topic, on links between family activities and social security (2) and on main arguments for family policy and its design in particular when realised by social security schemes (3). In a second part the situation in Germany is presented as a case study illustrating major instruments already implemented (4) and important topics that are discussed in improving the situation of families by means of social security and effects linked to various measures (5).

The main focus of the paper is on the links between the family and social *insurance*. In Germany social insurance is the major part of social security arrangements. At present the topic „family and social insurance“ is much debated in Germany. An important reason is a decision of the German Constitutional Court of Justice of 2001. According to this decision, families with children have to be burdened less by contribution payments compared to persons without children in the quite new statutory (social) long-term care insurance.<sup>1</sup> What makes this decisions highly interesting from a general point of view as well as in the German political process is that government and parliament are obliged to check whether families with children are burdened too much also in other pay-as-you go (PAYGO) financed social insurance schemes like health insurance and particularly in pension insurance. Several important and fundamental questions are linked hereto. The answers given can change above all the structure of social pension insurance.

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<sup>1</sup> Long-term care insurance was introduced in Germany in 1995 as the fifth branch of social insurance beside accident, health, unemployment and pension insurance. See for example Schmähl and Rothgang (1996).

## 2. Family activities and social security

Activities of families regarding social security are manifold. First of all there are activities as *intrafamily* social security. Family members are supplying support for other members of the family for example in case of illness, in old age or when long-term care is needed. This often are transfers in kind like nursing and providing food in case of illness etc. But there can also be transfers in cash.

There are transfers within one generation – for example between husbands – and between generations, from the young to the old but also vice versa. The empirical information on intrafamily transfers in cash as well as in kind are often incomplete and less well documented compared to activities that are linked to *formal* social security schemes and arrangements. The expression formal social security is used here for those arrangements and activities that are not realised within the (extended) family.

Intrafamily social security can reduce the demand for formal activities as well as the need to collect taxes or social insurance contributions to finance formal activities in case of health care etc. (see Overview 1). But one has to take into consideration that intrafamily transfers are not without costs. This should be borne in mind when a shift from formal schemes towards the family is proposed based on the fact that this can avoid an increase in taxes or contributions. The same is true when a reduction in public schemes is linked to a shift towards private arrangements like in health care or in pensions. The public debate is often focused on the fiscal effects, especially the burden for public budgets, neglecting the additional burden in cash or in kind for private households resulting from a shift from public to private provision.

Regarding the link between formal social security arrangements and families it is useful to distinguish several aspects:

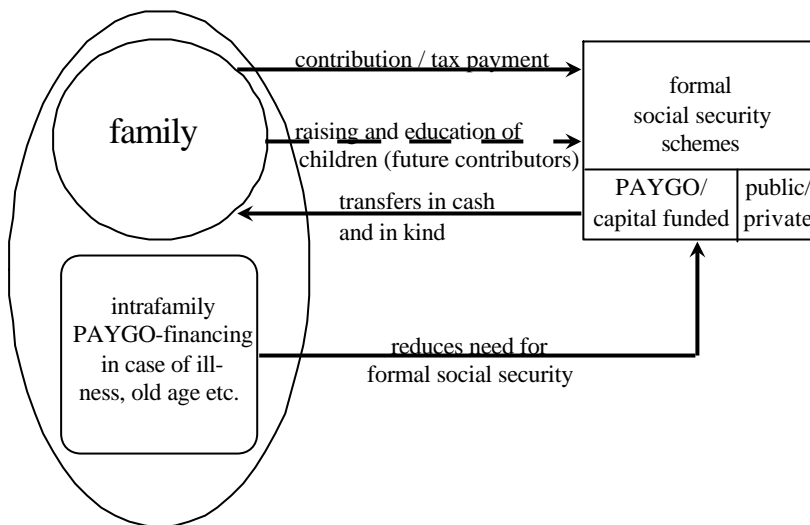
- (a) a cross-sectional as well as a longitudinal perspective,<sup>2</sup>
- (b) how families are contributing to social security schemes (in cash and/or in kind) and what they receive from the schemes,
- (c) whether the social security schemes are public or private,
- (d) financed in a PAYGO financed or capital funded scheme and
- (e) whether financing (collecting revenue) is by insurance premiums, by social insurance contributions or by taxes.

Obviously these are also dimensions that are relevant for characterising the concept of social security and in particular social insurance schemes.

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<sup>2</sup> This, among other things, is relevant in the topic discussed below regarding externalities of raising children in PAYGO and capital funded (pension) schemes.

*Overview 1: Families and social security*



In order to accumulate claims for social security, families can pay insurance premiums for example in private life or health insurance or can contribute to social insurance schemes. And families pay taxes (direct and indirect taxes) which are also used to finance transfers for families themselves.

It is often argued that families contribute much more than only by monetary transfers towards public budgets or private insurance companies, namely by raising and educating children (see once more Overview 1). Children will be future contributors and tax payers. The argument often used is that without children PAYGO schemes will not survive or will have severe financial problems in case of low or even decreasing fertility rates because PAYGO financed schemes need future contributors. This argument will be discussed below.

There is also the argument, that introducing and designing PAYGO financed social insurance schemes – in particular the pension scheme – gives negative incentives for raising children, because these schemes provide pensions in case of old age (or disability) even then when the person never had raised a child. Children of other families will finance the living in old age not only of those persons who have raised children but also of childless persons.<sup>3</sup>

This leads directly to arguments supporting the demand for improving the living conditions of families which are outlined next.

<sup>3</sup> See for example Nugent (1985); Cigno (1992); Sinn (1990, 1998).



### 3. **Basic economic arguments for family policy and basic decisions in designing family policy**

Reviewing the economic arguments for measures in favour of families there are in particular two lines of argument based on allocation and distribution:

*Allocation:* Families contribute to the creation and improvement of human capital in a society as a whole as well as for specific institutions like social insurance. This is an argument for rewarding what families do, for an allocative family policy. This argument is not based on the burden of caring for children etc. but on the welfare gains a society has by participating in the existence of children and the education children receive within the family.

*Distribution:* To raise children is not without costs. There are direct costs for caring for children etc., but also costs like foregone wages in case of not being employed or only employed part-time instead of full-time. Some equalisation measures are needed to compensate at least partially for these costs families have to bear.

Both types of argument are often used together when proposing specific measures. But there is also a third type of argument.

*Population Policy:* A further argument is not only to reward the contribution of families for society or social insurance by raising children but to give incentives for increasing the number of children. This pro-natalist argument was not much used directly in Germany for a long time.<sup>4</sup> However, some demographers and persons very much engaged in family policy argue in favour of a population policy pointing at the challenges arising from a reduction in the number of people and from demographic ageing as well as from problems to compensate (at least part) of the deficit in the number of births by importing people, that means by an active immigration policy. The costs of integrating immigrants can be high because it must be expected that a great number of immigrants will come from countries with quite different cultural heritage. The reason for this is that most of our neighbour countries and highly industrialised countries in general are more or less facing a similar demographic development and therefore will not be a remarkable source of immigrants for Germany.

In economic literature the argument based on allocation is a prominent one. It is also important in the debate on social security and family policy. Raising children has positive externalities for the whole society and especially for those who did not raise children. Families therefore should be compensated in general and in particular within social insurance schemes.

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4 After the Second World War it was a taboo for many years to argue along this line because of the negative experience made in Germany during the Nazi period with a „population policy“.

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It is sometimes argued by economists that PAYGO schemes give negative incentives for having children – children are no more necessary for parents as provider of old-age security. The elderly – so the argument – will receive a pension in a collective pension scheme whether they have raised children or not. Therefore these schemes are a major reason for the low fertility rates to be seen in many industrialised countries. However, empirical evidence on this is not convincing at all. This is not surprising because it is difficult to isolate the effect of the introduction and the design of PAYGO schemes on fertility behaviour. Even the cause and the effect are not clear. For example, if the extended family as provider of protection and support in old age becomes weaker this may stimulate the introduction of formal pension schemes and not vice versa. This was a major reason, for example, to introduce social insurance in Germany in the late 19<sup>th</sup> century.

However, the introduction of funded schemes – following the line of argument regarding negative incentive effects on fertility – would also reduce the necessity to have children as means of old-age security. The introduction of a funded scheme would even burden families additionally because – as is well known – the shift from PAYGO financing (here intrafamily PAYGO financing) to funding increases the burden of those being in their working age –, if the level of old-age provision for the present elderly is not reduced remarkably.

When proposing measures in favour of families it has to be decided in what *phase of the life cycle* these measures shall become effective. It is obvious that additional costs for families will arise in the period of raising children, direct costs for financing the living of children and opportunity costs in case of staying at home and being not employed (or employed on a reduced level). If – like in Germany – claims in social insurance are based on contribution payments mainly from labour income, not being employed affects future pension benefits. There are in principle two different strategies to cope with this problem of direct costs and opportunity costs during the period of raising children: To improve the possibilities of parents to combine caring for children and employment. This is in particular depending on infrastructure like care facilities, all-day schooling etc. This, for example, cannot be realised by measures of social insurance. Another approach is to improve the possibility for parents to stay at home and care for children and not to be employed. This must not be focused on women alone but on both parents. Here above all transfers in cash can help to give the opportunity to stay at home for some time and to spend more time for child care. But also measures within social insurance may help to realise this objective.

Behind these two approaches there are different normative positions, especially whether for example to be employed is the norm and therefore everything should be designed in such a way as to realise employment also of both parents – and in particular of mothers.<sup>5</sup> Or

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5 This requires – as already mentioned – a specific infrastructure. But also social security schemes can be designed in such a way that they provide incentives for taking up employment while staying at home becomes more costly. For example proposals for a minimum contribution rate (in pension insurance) for all citizens, independent whether employed or not, could give an incentive

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whether caring for children within the family (at least for some years) without being employed is supported and looked upon as useful for society.<sup>6</sup>

There can also be measures to improve the financial situation of parents when they are retired. This can be done for example by crediting pension claims because of former periods of child care. While this becomes effective in old age by a higher pension it can, however, also be argued that this reduces the costs in pension insurance in the pre-retirement period because, if the mother or father wanted to accumulate this additional pension claim, she or he had to pay a higher contribution.

In the following, the *German* situation is outlined with regard to some basic information on how families are treated within social insurance (4). Then the present debate on improving the conditions of families within social insurance and social security in general – caused by a decision of the Constitutional Court – as well as the basic instruments proposed in the discussion will be analysed (5).

#### **4. Transfers to families from public budgets and by social insurance in Germany**

There exists a great variety of transfers in favour of families in Germany, mainly from public budgets. Overview 2 gives some macro-data. Beside transfers in cash and tax expenditures for families with children by different programs (as direct instruments of family policy like child benefits, tax allowances, maternity, parental and childcare leave, but also as transfers linked for example to housing subsidies) there are price subsidies and transfers in kind like public education without fees, public child care facilities. The global figures on public expenditure for families with children given in Overview 2, however, are not comprehensive regarding public instruments and neglect private expenditure, for example those provided by firms (employers). Starting in the year 2002, there are now also additional subsidies (transfer payments or tax expenditure) for families in case of saving in certified types of private pensions.<sup>7</sup>

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for taking up employment – or may make it necessary by financial reasons because of the additional contribution burden.

<sup>6</sup> For an overview of different approaches see Kaufmann et al. (2001).

<sup>7</sup> These certified capital funded products are designed as a substitute for a reduction of PAYGO financed social pensions. For a discussion on this as well as the regulations regarding private pensions see Schmähl (2003).

Overview 2: *Public expenditure for families with children in Germany*  
– year 2000 –

	thousand million Euro
tax expenditure	37.3
transfers in cash from public budgets (federal, state and local level)	26.9
among this	
<i>contribution payments to social pension insurance for years of child care</i>	11.5
transfers in kind from public budgets <sup>1)</sup>	71.0
transfers in cash from social insurance <sup>2)</sup>	16.0
total	about 150
<sup>1)</sup> 1999	
<sup>2)</sup> including “contribution expenditure” (contribution-free insurance) in health insurance of <i>children</i> only and transfers in kind in case of pregnancy and motherhood	

Source: Deutsche Bundesbank (2002: 19).

According to this overview by the German Bundesbank (2002) about 16 thousand million Euro (more than 10 % of all public expenditure for families) are financed by social insurance schemes. But there is another important sum financed by federal budget but relevant for social pension insurance, namely contributions paid by the federal public budget to social pension insurance for years of child care that are credited in the individual account of social pension insurance. This is a relevant topic when discussing the role of transfers for families *within* social pension insurance (see below). Taking these two positions together, about 20 % of all family-oriented public transfers are linked to social insurance in Germany.

In *social insurance schemes* there exist a variety of measures focused on families. Without being comprehensive the following instruments shall be mentioned (see Overview 3):

Overview 3: *Instruments used in social insurance in favour of families*

health insurance	long-term care insurance	unemployment insurance	pension insurance
coverage of non-working spouse and children without own contributions		higher benefits for insured persons with children	credits for years of child care
benefits in case of pregnancy and motherhood	contribution to pension insurance in case of family care		fictitious increase of earnings
			higher widow(er)'s

pension if children were born
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- In *unemployment insurance* unemployment benefits for insured people with children are higher compared to benefits for persons without children.
- In *health insurance and long-term care insurance* children as well as the non-working spouse (that means not being employed) are covered without paying own contributions or without the husband paying contributions for them. In health insurance there are also benefits in case of pregnancy and maternity.
- In *pension insurance* several instruments are used in favour of families. Overview 4 gives information on five instruments used in Germany.<sup>8</sup> As already mentioned, a contribution is paid from the federal budget in case of caring for children (for 3 years per child based on average earnings). This affects the pension of the insured person. The rules for crediting these years has changed over time. In the future there will also be a bonus for widow's/widower's pensions in case the person had a child. Several other instruments are used to improve the pension benefit in old age or in case of disability if contributors had periods of child care during their working life.

*Overview 4: Instruments in social pension insurance focused on families*

(1) *Crediting years of child care*

- number of years
- Earnings Points (EP) per year

1986    1 year        0.75 EP  
          *but own earnings replace the credit*

1992    3 years        0.75 EP

1999                    gradual increase to

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<sup>8</sup> For a better understanding of these instruments it is necessary to mention that the individual pension claim in social pension insurance is based above all on the following two factors in case of employment:

(1) the relative amount of gross earnings, i.e. individual gross earnings (in a specific year) divided by the average gross earnings of all insurance persons in this year (Earnings Points) and (2) the number of years of insurance. If individual earnings is just as high as average earnings, one Earnings Point is credited in the individual account in social pension insurance. Pension calculation takes into account the sum of all Earnings Points. In addition to Earnings Points from periods of employment there are for example Earnings Points based on contributions from health insurance, unemployment and long-term care insurance as well as by the state. But there can be also a crediting of Earnings Points without a contribution payment (e.g. for some years of schooling).

1 EP (July 2000)

*but* now in addition to own earnings

(maximum up to 2002 about 1.8 EP = contribution ceiling)

- (2) 1992  
*Fictitious years of insurance* in case of child care to compensate existing gaps in insurance career as a precondition to fulfil waiting periods for taking up e.g. early retirement pension for women at age 60.
- (3) 2001  
*Fictitious increase of low earnings* in case of child care (age 4-10) if earnings is below average earnings by 50 %, maximum 1 EP. Precondition: waiting period of 25 years. 10 years of fictitious years of insurance in case of child care (see 2) are counted for this waiting period.
- (4) 2001  
*Supplementing contribution payment* of long-term care insurance (to pension insurance) by 50 % up to 1 EP (*maximum*) in case of care for a handicapped child (up to age 18).
- (5) 2001  
*Widow(er)'s pension* will be reduced from 60 % to 55 % of the pension of the former spouse and all own income will be taken into account for the calculation of the benefit. But there will be an increase of the pension for the first child by 2 EP and 1 EP for other children.

In case of caring for frail elderly by family members the long-term care funds pay a contribution to pension insurance in favour of the caregiver to improve the pension claim which is expected to become lower because of not taking up employment because of the care given to (in most cases) a family member. The contribution payment (and therefore also the pension claim linked to the contribution) differs according to the category of care dependency.<sup>9</sup> In case of caring for an disabled child this contribution is upgraded.

Regarding *financing* of these elements of family policy used in social insurance schemes, there exist important differences. For example, in health and long-term care insurance the contribution-free coverage of children or the non-working spouse is financed by contribution revenue of all other contributors. That means, the expenditure are financed by earnings-related contributions (contributions based on gross earnings up to a ceiling) and paid on equal part by employees and employers.

In contrast to this, it was a clear political decision that crediting years in case of child care in the social pension insurance is a matter of family policy. Because the (federal) state is responsible for family policy, all tax payers are obliged to finance these measures. It is obvious that the effect on income distribution is different if financing is by proportional earnings-related contributions (up to a ceiling) or by a (progressive) tax on income or a value added tax.

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<sup>9</sup> There exist three degrees in the new German long-term care insurance scheme.

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The existing differences for example in financing of family policy in health insurance as well as in long-term care insurance compared to pension insurance can be explained to a large extent from history: In the founding period of Germany's social insurance in the eighties of the 19<sup>th</sup> century chancellor Bismarck could not realise financing part of health insurance by taxes. A few years later, when pension insurance was established, 30 % of pension expenditure were financed from tax revenue beside employer's and employee's contribution.<sup>10</sup>

Until some years ago, there was strong resistance in the German public debate regarding partial tax financing in health insurance and the effect in particular on employer's contributions (as non-wage labour costs). This now starts to change mainly because of increasing contribution rates in health insurance. In particular, part of benefits in health insurance towards families is looked upon now as family policy by some actors. While family policy in general is financed from tax revenue in Germany, it is argued that a shift in financing from contribution to tax financing should take place.

## **5. The present debate in Germany on improving the conditions for families in social insurance**

As already mentioned, in March 2001 the Constitutional Court decided that in long-term care insurance there is at present an unequal treatment of insured persons with and without children which violates the constitution. The main argument was that insured persons raising children contribute additionally beside their contribution payment in cash, because a PAYGO financed scheme needs future generations. Therefore, families produce a contribution in kind. This second type of contribution is according to the Court not – at least not adequately – recognised. Therefore, the Court demanded a reduction of contribution payments in cash for families. This has to be implemented by the legislator up to the end of 2004. But the legislator has also to examine whether the effect criticised in long-term care insurance does also exist in other PAYGO financed social insurance schemes.

### **5.1 Raising children as a contribution in kind in pension insurance?**

This instruction by the Constitutional Court can have far reaching effects particularly in social pension insurance. If the Court's argument that raising children is a contribution in kind is accepted in pension insurance, this would undermine the present earnings-(income-)-related concept of pension insurance. If pension claims are based on the fact of raising children this

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<sup>10</sup> An important argument to realise this was the fact that the introduction of the pension insurance reduced the expenditure for poor people on the local level.

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only can mean, that the pension claim is not earnings-(income-) related but only flat rate. This would change the present concept of the German pension insurance scheme fundamentally.

There is now a debate going on, how to react to the demand of the Constitutional Court. It will be important to analyse the arguments of the Court as well as the effects of instruments that can be used to improve the financial situation of families during the period of raising children.

The argument that raising children is a contribution to PAYGO financed schemes and should be rewarded within the pension scheme was already put forward in the past and sounds very plausible for the moment. Since many years, proposals have been existing to make the contribution payments depending on the number of children.<sup>11</sup> This can be done in principle by different contribution *rates* but also by implementing a flat rate *allowance* (depending on the number of children) into the formula for calculating the contribution payment. On the other hand, there exist proposals to differentiate the *pension benefit* according to the number of children, for example giving the full pension benefit only to those insured persons that have raised 2 children (more or less the number of children necessary for realising a constant number of births).

The main argument behind these proposals as well as the decision of the Constitutional Court is that raising children has positive externalities for other persons. In particular, the children will be potential future contributors to social insurance. The external effect of this has to be internalised by improving the income position of families.

Before discussing different instruments for internalising externalities, some more general questions will be mentioned that have to be answered when deciding on the ways and means to improve the conditions for families raising children.

Regarding externalities, for example regarding future financing of social insurance, not only the number of children is decisive but above all the human capital of children and the future productivity of children during their working life. But how can the externalities of raising children be quantified? This – following the argument of those who base their proposals on externalities – has to be done in all areas, that means in the different social insurance schemes as well as for the whole society in general. Following this line of argument, it is not adequate to limit the improvement of living conditions of families only to those families who are contributing to a PAYGO scheme. For example, if parents are members of a mandatory funded scheme – as in Germany for professional associations like lawyers, doctors, architects and some other groups of self-employed – then their children will to a high percentage become members of a PAYGO scheme in the future, while on the other hand parents being

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11 See Schmähl (1988) for a discussion on this and for further references. Horstmann (1996) gives an overview of different proposals how to compensate families within social pension insurance in case of raising children.



now member of a PAYGO scheme may have children who later contribute to a funded scheme.

This already points at a difficulty if the argument for improving the conditions for families is based on effects for PAYGO schemes only. And it would be a misunderstanding of reality to assume that funded schemes are not depending on future gainfully employed people. It cannot be assumed that the development of capital markets is independent of the development of employment and the labour market as well as of the age structure of the population and thereby the number of persons saving and accumulating financial capital and those persons who reduce their capital stock (financial assets) to finance their living in old age.

Coming back to the question how to quantify the externalities as a base for calculating how much, for example, the contribution burden of contributors with children should be reduced compared to those contributors without children, one needs some information regarding the effect of the activities of the family on human capital development of their children. This is not only depending on parents' activities. There are other influencing factors like schooling, training and retraining in firms, own investment by children themselves and how they use their ability to earn money as a base for contributing to social insurance schemes or paying taxes.

Taking these aspects into account, some conclusions can be drawn regarding the ways and means for improving the income position of families for internalising externalities (and not for compensating economic costs of raising children):

- These measures cannot be targeted only at parents contributing to PAYGO schemes but also have to include members of those mandatory funded schemes that are elements of the first tier of pension arrangements.
- If there are externalities for several social insurance schemes as well as for the society in general, then implementation of measures into each of the schemes – despite the fact of great difficulties to quantify externalities – would undermine transparency of family policy and would increase transaction costs. The conclusion is that these measures should not be financed from specific levies for specific schemes like earnings-based social insurance contributions of different branches of social insurance but in principle from tax revenue. In order to increase transparency and to improve the possibility of a rational family policy, an integration of various measures within one organisation might be useful. This will be discussed below.

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## 5.2 Reducing the contribution burden of families – instruments and effects

It has to be discussed and politically decided in Germany how to react to the request of the Constitutional Court to reduce the contribution burden of families within social insurance schemes. If this is regarded to be necessary (not only in long-term care insurance but in other schemes as well), then it has to be decided who has to finance the deficit resulting from a reduction of contribution payments of families and what is the adequate assessment base for these payments.

One possibility often mentioned in the German discussion is to implement different contribution *rates* according to the number of children. This could only be realised for the employee's part of contribution payments only and not for the employer's contributions because of otherwise distorting effects regarding labour costs on the labour market. Contributors without children would have to pay higher contribution rates compared to those contributors with children. The reduction of contribution rates for contributors with children affects these contributors differently according to their earnings: Contributors with higher earnings would gain more per child in absolute terms compared to those with low earnings. Therefore, it was proposed to use a fixed absolute (flat rate) amount of an *allowance* per child. Here, the absolute reduction of the contribution payment would be identical for all contributors but relatively higher (compared to the individual earnings) for those in the lower income brackets.

Introducing an allowance into the contribution formula would have several additional effects: Up to the ceiling the contribution scale would become (indirectly) progressive. The effective contribution rate (defined as individual contribution payment as ratio of individual gross earnings) would remain below the contribution rate<sup>12</sup> and is regressive for earnings above the (upper) ceiling. Overview 5 illustrates the effect of introducing an allowance into the formula for calculating the contribution payment.

The introduction of an allowance would not affect the individual pension claim, because in German social pension insurance the pension claim is based on the amount of individual earnings and not (as in a defined contribution scheme) on the amount of the contribution payment. However, the contribution revenue would be reduced by introducing an allowance as well as in reducing the contribution rate for families with children.

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12 Only if the upper ceiling is increased by the amount of the allowance, contributors with earnings at the new ceiling would have an effective contribution rate just as high as the (formal) contribution rate. For a detailed discussion of effects of allowances in calculating the contribution payment see Schmähl (1977: 165-190).

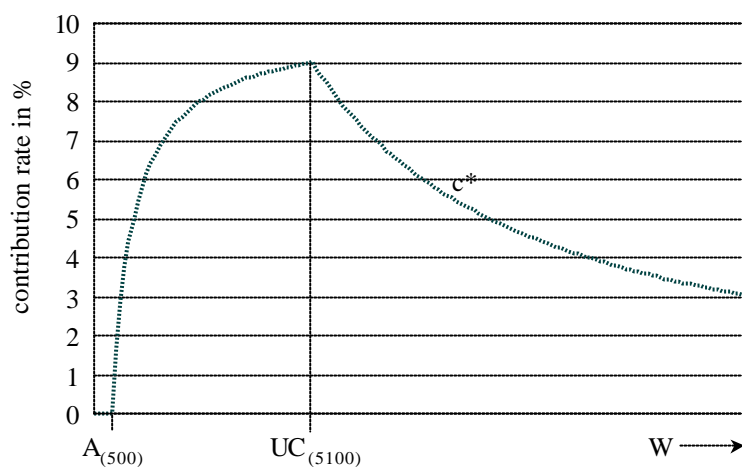
Then it has to be decided *how to finance the deficit* of the social insurance scheme in case of reducing the contribution burden of contributors with children. As already argued<sup>13</sup> the adequate way to finance this deficit is from tax revenue and not by earnings-related contributions up to a ceiling – as it is done at present in health and long-term care insurance in Germany because of contribution-free insurance of non-working spouse and children. There are distributive arguments against this (because expenditure for family policy would not be financed according to the ability to pay but only based on income from labour up to a ceiling) as well as arguments regarding the effect on the labour market: Financing family policy by earnings-related contributions increases labour costs which negatively affects labour demand and may increase unemployment.<sup>14</sup>

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13 Either on the base of utility of raising children for the society in general or regarding the lack in transparency and goal-oriented targeting of measures of family policy in case of trying to compensate externalities in several different branches of social insurance, other branches for providing social security etc.

14 This is discussed in Schmähl (1998).

Overview 5: Effective contribution rate in case of an allowance



$A$  = allowance (500)

$UC$  = upper ceiling (5100)

$c$  = contribution rate (10 %)

$W$  = (individual) gross earnings

$c^*$  = effective (individual) contribution rate

$$c^* = \frac{c(W - A)}{W}$$

for  $W \leq UC$

Disentangling employee's and employer's contributions – which would result from the above mentioned two strategies (different contribution rates or allowances) – could stimulate (at least in Germany) a more fundamental discussion about the assessment base for employer's contributions. This was discussed in Germany (as well as in some other European countries like Austria and Belgium) in the past. It was proposed not to base employer's contributions on earnings only but on (gross or net) value added of the firm. Because of the different ratios of labour costs to value added in different branches of the economy contribution payments based only on earnings are burdening in particular labour-intensive production.<sup>15</sup> Such a value added levy of employers, however, would in fact be a tax that cannot be allocated to the individual employee as in case of earnings-related employer's contributions which are part of

15 For a detailed analysis see Schmähl et al. (1984) and Schmähl (1992).

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individual earnings of the employee. In a pension scheme like in Germany, where the idea of a close contribution-benefit link is important at least up to now, the shift from earnings-related employer's contributions to value added tax would dilute the contribution-benefit link and make the social insurance scheme more interpersonally redistributive.

It is obvious that a decision about adequate financing of family policy implemented into social insurance schemes depends also on the concept of social insurance that is seen as relevant in a country. If social insurance schemes are highly redistributive, the above argument of diluting the contribution-benefit link seems not to be relevant. Of course, the argument of a lack of transparency, higher transaction costs and the problems in properly targeting all elements of family policy which are distributed over several schemes and public budgets remains relevant.

To base pension claims on raising children – the contribution in kind – in German pension insurance, would require that the pension claim is not income-related but flat rate. This, however, also would change the German pension scheme fundamentally, because up to now the scheme and the formula for calculating pensions are explicitly earnings-related.

In the case of Germany and in particular regarding the social pension insurance instead of differentiating contribution rates or contribution payments (by an allowance), the following approach seems to be preferable if – as demanded by the Constitutional Court – a reduction of contribution burden for families shall be realised: This can be done by direct transfer payments financed by general public revenue (a) either to the pension insurance or (b) to the household of the contributor.

In case (a) the contribution payments of families with children would be reduced and the resulting deficit of the pension insurance would be compensated from general public revenue. In case (b) families raising children would receive a direct transfer payment aiming at a reduction of their contribution or – more generally – of their provision for old age in a pension scheme belonging to the first tier of the pension arrangements (that means arrangements being the base for old-age security of groups of people, whether funded or PAYGO financed). The amount of this reduction could be equal per child.

It could, however, be argued that financing of family policy from general tax revenue may burden families, especially if a high percentage of tax revenue is collected via indirect taxation – like value added tax, purchase taxes or ecological tax. To avoid this, there could be for example a surcharge in income tax (whether earmarked for family policy or not) designed in such a way, that families with children are more or less exempted from paying this levy.

To go one step further in trying to make the effects of family policy more transparent and to improve the possibility to realise the political objectives of family policy an institution could be

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established which handles at least all transfers in cash in favour of families as well as the financing of these transfers (a „caisse familiale“, in German „Familienkasse“).<sup>16</sup>

It is, however, not intended by the German government to realise such an approach. A main reason is that government tries to reduce the volume of the *federal* budget and not to extend it by taking over tasks that are now realised within social insurance or at least the financing of these tasks by tax revenue.<sup>17</sup> Therefore, the German Government plans to fulfil the demands of the Constitutional Court regarding long-term care financing by *increasing* the contribution burden of those contributors who are not caring for children. This additional burden will also affect those contributors, who raised children in the past. This measure is focused on the period of child caring and therefore is not an instrument to compensate families because they raised children which produces (positive) external effects for other persons in various institutions or for the society in general.

### 5.3 Financing of family policy and human capital formation

In general, there seems to be a great consent in Germany about the objective of improving the economic situation of families with children during the period of raising and educating children. The realisation of this can be an important element in a strategy of increasing human capital. The development of human capital is of decisive importance for future productivity gains and improvement of the well-being of the population. Improving the possibilities for higher productivity by education within the family – among other things also by passing on social values – as well as in education in general, training and retraining in an ageing society seems to be of utmost importance. Therefore, it should be decided how to allocate tax revenue for different types of capital formation. My personal view is that in Germany recent decisions in allocating scarce public resources aim too much towards formation of financial capital and not into human capital formation. However, these decisions were very much according to the “spirit of the age“ (“Zeitgeist“) and were in the interest of influential actors of the capital markets. Decisions in German pension policy illustrate this very clearly.<sup>18</sup> The discussion on the role of families and how to improve their economic situation could, however, be a chance to redirect public attention as well as public money more towards human capital which is a central base for future economic competitiveness and development as well as for the economic well-being of the population.

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16 This proposal is not new in Germany. It was an element of the proposals of an expert commission of the federal government for preparing pension reform in 1997, but not implemented.

17 The obligation to fulfil the Maastricht stability criteria is an important political argument to repel proposals like the one presented above.

18 The instruments for realising this are discussed in Schmähl (2003).

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