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## The “Machine contribution” in the European scene

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will be required for mutual information and coordination, and, last but not least, to the trustworthiness of one's local partner. In consequence, the "transaction costs" incurred can be substantially higher than they would be for pure export deals or for an involvement via a fully dependent subsidiary. Against this must be weighed the expected benefits from the arrangement. To an increasing extent, the motivation for seeking entrepreneurial cooperation is no longer simply the pressure exerted by domestic legislation in the developing country to set up production facilities there with locally based equity participation. Instead, a part is also played by expectations that cooperation will provide access to local know-how and capital, to be better able to integrate the company into its foreign environment and to obtain support on the part of the host country's government – via the receipt of public contracts, for example.<sup>25</sup>

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<sup>25</sup> Cf. D.-S. Ahn: Indigenisierungstendenzen und Joint-Venture-Praxis in ASEAN-Ländern, in: K. Hottes, Chr. Uhlig, op. cit., p. 291 ff.; C. Pollak, op. cit., p. 132 ff.

Before companies from industrial countries deepen their involvement, however, they not only need to be familiar with entrepreneurial cooperation as a tool in itself, but also with the conditions which need to be fulfilled if its application is to be a success. The important point is, by carrying out systematic market research, to gain a realistic grasp of national conditions and structures, to gather well-founded knowledge of the host country and the customs which apply there, to make a careful choice of partner, and finally to ensure that agreements are contractually bound in unequivocal legal terms. It is also of prime importance to see that the staff who will be sent to the country concerned are well prepared in that they too have learned about the cultural background and have some knowledge of the local language. That is to say that not only economic, legal and political matters require attention, but also the cultural and social conditions in the partner country if the cooperation is to be a success. In broadening the information base all of this requires, great help can be provided by the results of development research.

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## SOCIAL POLICY

# The "Machine Contribution" in the European Scene

by Jan Peeters, Antwerp\*

**The long-term financing of social security faces considerable problems which give rise to the question whether wages can and should continue to serve as the only assessment basis for social security contributions. The calculation of, at least, the employers' contributions on a broader value added based foundation seems to offer a plausible alternative: human labour is being replaced more and more by technology: its value added could be used for financing social security. What would be the economic effects of such a "machine contribution" on employment, competitiveness and growth?**

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In only a minor group of EC countries is the financing of social security based mainly on tax revenue, namely in Denmark, Ireland and, to a lesser extent, the UK. In the other countries social security financing relies mainly on employers' and employees' payroll contributions. These contributions are not always calculated on the basis of total gross wages: upper earnings ceilings exist in the Netherlands, Greece, the Federal Republic of Germany, France and Luxembourg. There is, however, a tendency to eliminate these

ceilings, e.g. in Belgium (1982) and in the UK (1985). In some countries (the Federal Republic of Germany, France and Italy) more than 40 % of total social security revenue comes from employers' contributions (see Table 1).

These social security financing structures have implications for the structure of labour costs in the different countries (see Table 2). In some countries social security contributions constitute a very substantial cost factor with, moreover, some very specific characteristics: these costs are fixed in a non-

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economic way within an institutional framework, in which government, employers and labour pursue a social policy using norms mainly of a social and political (but not economic) nature.

Therefore it is not very surprising that contributions based on wages are being questioned, mainly in countries such as the Federal Republic of Germany, France, Italy, Belgium and the Netherlands. This does not mean that there is no discussion in the other countries. However, in countries which rely to a large extent on taxation the tendency is to stress the difficulty of pushing tax up even further, while in countries with high payroll contributions there is an attempt to show the perverse economic and social effects of these contributions, and what would happen if they were calculated differently. What are then the social and economic effects of payroll taxes?

### Criticism of the Current Financing Method

A distinction is often made between the calculation of the employee's contribution and that of the employer's contribution. The calculation of the employee's contribution has disadvantages of a mainly social nature. Payroll taxes are calculated only on the basis of labour income, not on property or capital income. This makes them regressive in relation to total disposable family income, since the share of non-labour income grows with total income. This regressivity is strengthened when upper earnings ceilings are used in the calculation of contributions. Moreover, these ceilings favour households with just one earner, given a certain income level. These regressive contributions are the more regrettable when taking into account the benefit side of social security; there the so-called "Matthew effect" can be seen, i.e. in general higher income groups receive relatively more benefits than lower income groups. This happens in particular in schemes such as family allowances<sup>1</sup> and health care. This means that there is a risk of "perverse" redistribution.

Although there is a lot of agreement on these social criticisms, they do not seem to be a decisive factor in the search for a better method of financing social security. On the other hand, the calculation of the employer's contributions and its negative economic effects certainly is a crucial stimulus to the reform discussion. The advocates of a "machine contribution" mainly refer to two mechanisms:

- ☐ Payroll contributions create distortions in firms'

competitiveness because of unequal social security levies.

- ☐ Payroll contributions are responsible for the substitution of capital for labour because of the distortions in the relative costs of production factors.

Corresponding to this, they point out that the financing of social security using wages as an assessment base is becoming precarious because of the substitution process and because of demographic trends. This problem is worsened by present policies, as every measure to moderate income leads to fewer social security receipts. Are these valid arguments for changing the contribution base?

### Discriminating Parataxation?

In contrast to widespread belief, the distortions in competitiveness do not occur on the international level.

Especially in France and Italy complaints are often heard about their firms being penalized on the international market because of the dominant share of employers' contributions in social security financing. It is argued that this penalizes them in relation to firms from countries that rely more on taxation. However, only the total labour costs matter for competitiveness. The comparison of Tables 1 and 3 shows that the financing method, i.e. the choice between relatively low wages and high employer contributions (as in France or Italy) on the one hand, and relatively high wages and low social contributions (as in Denmark) on the other hand, is not correlated with the ultimate differences in total labour costs. Thus the choice between taxation or parataxation does not *a priori* distort international competition (see Table 3).

**Table 1**  
**Social Security Financing in the EC**  
(1983)

	Employers' contributions	Employees' contributions	State Subsidies	Other	Total
Netherlands	32.0	36.3	18.3	13.4	100
Belgium	39.2	16.8	39.8	4.2	100
Luxembourg	33.1	25.6	32.8	8.5	100
FR Germany	40.2	29.6	26.8	3.4	100
France	52.8	23.6	20.5	3.1	100
Italy	53.3	13.9	30.6	2.2	100
Greece (1977/78)	37.4	37.3	21.7	3.6	100
Denmark	9.8	3.6	81.9	4.7	100
Ireland	23.0	12.5	63.3	1.2	100
UK	31.8	15.9	43.4	8.4	100

S o u r c e : Commission of the European Communities, March 1985.

<sup>1</sup> Only in Greece are family allowances partly financed by employee contributions.

On the other hand it is certainly true that all empirical studies measure very serious differences in social levies between the various branches of the economy (indicated by the proportion of social levies in the total value added of the branch). Most of the traditional industrial sectors contribute more than agriculture, services or advanced technology branches. However, it makes no sense to speak of a distortion of competitiveness between branches of the economy; their products are complementary rather than substitutable. We can only speak of a distortion of competitiveness for individual firms within the same branch. Thus we can say that the measured differences in parataxation between branches do not really matter; it is true that it is not very "fair" that some sectors are taxed higher but, economically speaking, this has no serious implications as such.

In a recent report for the European Commission on the "machine contribution",<sup>2</sup> Pierik measured a certain parallelism in the social security burden of the same branches in different countries, i.e. the same branches always carry the heaviest burden. It is mainly technological developments and potentials that fix their position. Pierik illustrates this with data from Belgium, Germany and the Netherlands.

This means that, from the viewpoint of international competitiveness the current method of financing does not lead to distortions. Crucial here are the absolute differences in contribution levels: they are not created by the financing *method*, but by the *level* of social security in the different countries.

Also, the often heard complaint about small and medium sized firms being penalized can *not* be

confirmed: none of the empirical studies conclude that those firms are *a priori* hindered more by social security contributions.

The only economically problematic discrimination due to the financing method is thus situated on the national level within the same economic sector, namely between capital and labour intensive firms. On that level unequal parataxation leads to accelerated substitution of labour by capital in the penalized firms. This brings us to the second disadvantage of employers' payroll contributions.

### Capital-for-labour Substitution

There is general agreement that this disadvantage is very serious; certainly in recent years the search for alternatives has mainly been caused by the employment argument. Many authors agree that payroll contributions influence the capital-for-labour substitution process, but to a lesser extent than is generally believed by the advocates of a "machine contribution". Labour-capital substitution is linked to, and determined by, *several* elements:

□ The *technological* process: even without parataxation the rationalization trend would continue, though this process is encouraged and accelerated by the following factors which advance the profitability of rationalization investments.

□ The growing *total cost of labour* which, as already stated above, is not significantly affected by the percentage which employers contribute to social security revenue. Total labour costs include social security contributions, but also direct wages and additional, voluntary social benefits.

**Table 2**  
**Structure of Industrial Labour Costs, 1981**  
(in % of total labour costs)

	Direct costs				Indirect costs	
	Total	Direct wages	Premiums	Gratification for non-working days	Total	Social security
Belgium	75.6	55.9	10.1	9.3	24.4	22.2
Denmark	94.3	85.3	0.7	8.1	5.7	4.2
FR Germany	77.5	57.0	8.8	11.4	22.5	20.4
France	69.7	54.8	5.6	8.2	30.3	26.5
Ireland	84.1	73.7	1.0	9.3	15.9	12.9
Italy	73.7	54.0	8.8	10.7	26.3	24.6
Luxembourg	84.8	69.9	2.8	11.3	15.2	15.1
The Netherlands	72.6	56.1	7.9	8.4	27.4	24.4
UK	80.7	68.7	0.9	10.8	19.3	16.5
Greece	82.0	63.0	12.0	7.0	18.0	17.0

Source: EUROSTAT.

**Table 3**  
**Average Industrial Labour Costs per Hour, 1981**  
 (in ECU)

Belgium	12.08 <sup>2</sup>
Denmark	9.63
FR Germany	10.94
France	9.63
Ireland	6.03
Italy	7.40
Luxembourg	9.71
The Netherlands	10.73
UK	7.43
Greece	3.91

Source: EUROSTAT.

□ The systematic (artificial) *reduction of the cost of capital* by inflation, reducing the real rates of interest on capital loans and sometimes encouraging tendencies to over-invest, as well as by a number of measures and incentives to boost investment.

Thus, the financing method is only an attendant, but nevertheless an undeniable, factor in labour substitution.

Also undeniable is the fear of future social security financing problems if wages are the exclusive assessment base. This certainly applies to pension schemes. Probably the worst difficulty will not be the collapse of payroll revenue (the evolution of total wages is difficult to foresee), but rather the growth of expenditure. This threat stimulates the search for an enlarged assessment base; so far this problem seems to have been accorded considerably greater weight in the financing discussion in the Federal Republic of Germany than in the rest of the EC.

To summarize the problem analysis, it can be stated that the current wage contributions are criticized in a limited number of countries, not for social, i.e. redistributive, reasons (although there are some problems here), but mainly because of the economic disadvantages. At the beginning of the reform discussion, a lot of attention was paid to unequal parataxation on the international level and between industrial branches. To a large extent this criticism has disappeared and critics concentrate now on the heart of the problem: the emphasis on wages as the assessment base (together with other factors) pushes up the relative cost of labour, and therefore encourages unemployment in a marginal but undeniable way.

Let us first place the assessment base of the "machine contribution" within the broader framework of the possible alternatives to the present situation suggested in the literature.

Generally there are two options for encouraging employment by redistributing current social levies:

□ A *selective* reduction in labour costs by transferring social contributions from firms now penalized to firms that are now favoured. Such a selective reduction can be achieved by two techniques: (a) the maintenance of wage contributions, but with some minor modifications, e.g. the elimination of the upper earnings ceiling with a compensatory reduction of the contribution rate, or the reduction of some contributions for employers hiring additional labour in small and medium sized firms and/or large firms; (b) the enlargement of the assessment base to more, or all, elements of the firm's value added. This includes the introduction of a "machine contribution". There are several definitions of this concept in circulation, varying in the number of value added elements included. All variants will be included in the following in the term "machine contribution".

□ A *general* reduction of labour costs by transferring social contributions from firms to households. This can be achieved by a (partial) replacement of parataxation by taxation as a financing source, i.e. by lowering employers' contributions and increasing government subsidies to social security.

Nowhere in Europe has this financing method yet been introduced. We therefore have to rely on theoretical research to evaluate it. We summarize below the results of all major research simulations hypothesizing the introduction of value added (or part of it) as the assessment base for (a part of) the employers' contributions.

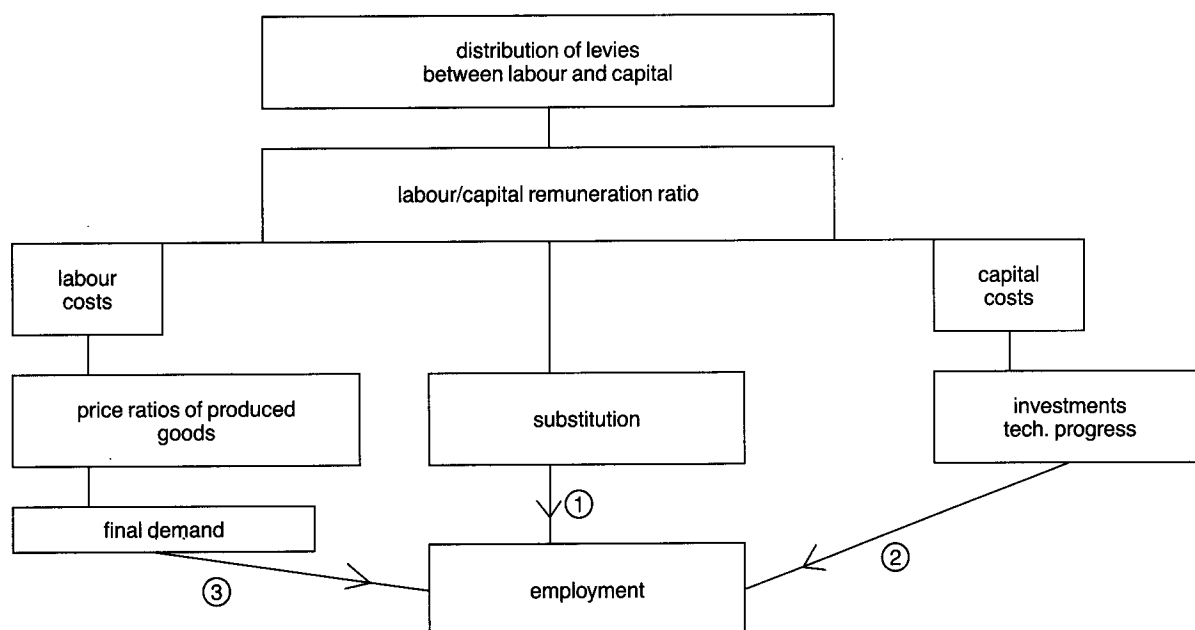
It should be noted that nearly all studies limit the enlargement of the assessment base to the *employers'* contributions. There are two reasons for this:

□ Many authors wish to maintain the traditional insurance principle in social security in that at least an unmistakable link remains between personal employee contribution and individual performance.

□ It is assumed that in the present economic context real increases in wages are extremely limited; the passing on of employee contributions to firms therefore seems unlikely, i.e. an increase in employee contributions no longer leads to higher labour costs, and thus no longer discriminates between firms with different factor intensities. Therefore it is sufficient to exchange only the employers' contributions for the more neutral value added based contributions.

<sup>2</sup> J. B. M. Pierik: De toegevoegde waarde als heffingsgrondslag voor de sociale verzekeringen; preliminary draft for the Report for the EC, August 1985.

Figure 1



### Simulation Results

Theoretically, the introduction of a "machine contribution" can influence employment via three channels (see Figure).

Labour would become cheaper in relation to capital, which would stimulate employment through channel 1. Indeed, since the profitability of rationalization investments would deteriorate, these would perhaps not be stopped, but would certainly be postponed. Via channel 2 employment can be influenced negatively when investment capacity, and thereby competitiveness and economic growth decrease in the long run. However, this can be counterbalanced partially if the lower investment capacity leads to more labour-intensive capital formation. Less investment leads to less final demand for capital goods, which could lead to a decrease in employment via channel 3. This negative effect on final demand could possibly be compensated for by an increase in demand for labour-intensively produced goods (which become cheaper).

What does research say about the final balance of these influences? Unfortunately for the policymaker, the results of several empirical studies are contradictory.

It is remarkable that only three French studies predict very substantial employment increases, namely the Ripert report<sup>3</sup> and two studies from the INSEE.<sup>4</sup> Each of the three channels from Figure 1 contributes to this effect.

Channel 1 shows considerable labour-for-capital substitution. The reduction of labour costs in the favoured firms is completely translated into price

reductions, which causes a considerable increase in final demand for labour-intensively produced goods (mainly in export); so channel 3 is also positive. Moreover, in channel 2 production techniques would be fallen back upon that are less capital intensive than would be the case without a change.

However, the assumptions of these French studies are criticized from all sides, and their positive effects have to be relativized. More limited positive results are found by a Dutch study by Stroecken<sup>5</sup> (+ 0.2 % jobs) and by the German group around Krelle.<sup>6</sup> The latter predicts negative results in the short term via channels 2 and 3 because of the investment capacity deterioration. After a while this is counterbalanced by positive effects in channel 1, so the substitution of labour for capital leads in the longer term to more jobs, although with a permanent slow-down of technological development, economic growth and the growth of disposable income.

<sup>3</sup> Commissariat Général du Plan: Assiettes des charges sociales et industries de main-d'oeuvre, Rapport au Premier Ministre (Rapport Ripert), Paris, June 1977.

<sup>4</sup> J. Maurice, P. Villa: Fiscalité et choix de la technique de production vus à travers une réforme de l'assiette des charges sociales, in: Annales de l'INSEE, 1980, Nos. 38-39, pp. 97-121; P. Artus, H. Sterdyniak, P. Villa: Investissement, emploi et fiscalité, in: Economie et Statistique, No. 127, 1980, pp. 115-127.

<sup>5</sup> J. H. M. Stroecken: De financieringsgrondslag van de sociale zekerheid als sturingsinstrument in het werkgelegenheidsbeleid, in: Maandschrift Economie, Vol. 47, 1983.

<sup>6</sup> D. Elixmann, H. Joerg, H. Kreuer, H. Sarrazin: Gesamtwirtschaftliche Auswirkungen alternativer Bemessungsgrundlagen für die Arbeitgeberbeiträge zur Sozialversicherung, January 1985. With an introduction by Prof. H. C. Wilhelm Krelle. (A study on behalf of the Federal Ministry of Labour and Social Affairs.)

The simulation results of the Belgian Planning Bureau<sup>7</sup> even indicate an increase in unemployment: the initially positive effects via channels 1 and 3 are more than cancelled out by the strong decrease in investments and in the ability to compete. Schmähl<sup>8</sup> finds similar results for the long term.

Two other studies, a Dutch one by Van de Klundert and Peters<sup>9</sup> and an Austrian one by Busch et al.<sup>10</sup> expect no considerable effects at all.

The only possible conclusion from the contradictory research results is that, as far as employment is concerned, no really decisive arguments for contributions based on value added exist. Even if there are positive effects in the short term, they are rather limited and only occur once, and are inclined to disappear in the longer run. Then only the permanent slow-down of technological progress, growth and competitiveness remains.

Since the employment effects are uncertain, what about the argument that there is a need for a broader assessment base to ensure future financing? In this matter considerably less empirical research has been done so far; some authors have made an ex-post comparison between the growth rates of several assessment bases in Germany (1961-1982), the Netherlands (1961-1982) and Belgium (1970-1983), and found largely parallel developments in Germany and in the Netherlands, while in Belgium value added increased less than wages (+ 327 % versus + 382 %). Of course we have to keep in mind that these are ex-post calculations based on a period in which wages increased exceptionally. Future developments remain uncertain and have to be studied more profoundly.

### Problems of Practicability

This international overview shows clearly that the benefits of a "machine contribution" are not very evident, and that there is no generally agreed policy recommendation. There is, however, consensus on the more practical problems of the applicability and

administrability of a value added based contribution. The most important ones are:

- ☐ What about individual firms or self-employed without hired labour now (and thus without wage contributions to be paid), but which create value added? Are they to be excluded from application?
- ☐ Definition problems: which concept of value added should be used? How should the value added of non-profit organisations, e.g. the public sector, be determined?
- ☐ Value added implies more possibilities of fraud, e.g. in the manipulation of depreciation methods.
- ☐ The need to introduce advance payments of contributions to avoid liquidity problems, since value added can only be measured with some delay.
- ☐ A very important objection of a rather "ideological" nature: some who are strongly committed to the link between individual labour, employers' and employees' contributions and benefits fear the loss of insurance principles in social security by the introduction of a value added based levy.

### Policy Recommendations

In view of the uncertainties and problems described above it is not surprising that nowhere in Europe any kind of "machine contribution" or value added based employer's contribution has been introduced yet. Nevertheless there remains the need for policy measures in the near future as the current wage based contributions are economically unwarranted and should be changed. We shall conclude this article with the policy recommendations of the official European Commission Report<sup>11</sup> on this matter, in order to give an impression of the challenge that governments are facing.

In the short term it would be preferable to correct the actual system of labour taxes in order to mitigate its perverse social and economic effects. This could be done by:

- ☐ the elimination of upper earnings ceilings everywhere (compensated by a reduction in the contribution rate in order to keep total social security revenue constant);
- ☐ the introduction of a general subsidy for employment, put into practice by exonerating part of the earnings of each employee from the need for a corresponding employer's contribution (possibly compensating the

<sup>7</sup> P. Hugé: Simple propos sur la sécurité sociale et sur son financement, Bureau du Plan, Brussels, February 1981.

<sup>8</sup> W. Schmähl, K. D. Henke, H. M. Schellhass: Änderung der Beitragsfinanzierung in der Rentenversicherung? – Ökonomische Wirkungen des "Maschinenbeitrags", Baden-Baden 1984.

<sup>9</sup> Th. Van de Klundert, P. Peters: Heffingsgrondslagen voor de premies sociale verzekering en werkloosheid: een macro-analyse op basis van een anticipatiemodel met hoeveelheidsrantsoenering, Economisch Instituut Katholieke Universiteit Nijmegen, May 1985.

<sup>10</sup> G. Busch, S. Hellmer, W. Korber, M. Mayer: Wertschöpfungsbezogene Arbeitgeberbeiträge zur gesetzlichen Pensionsversicherung, Wien 1984. (On behalf of the Federal Ministry of Social Administration.)

<sup>11</sup> Commission of the European Communities: Social Security Financing and effects on employment (V/42/83-EN), Brussels 1983.

reduction in receipts by an increase in the contribution percentage or by other means).

The technical methods for calculating such an exoneration could be the following:

- ☐ a floor, i.e. applying the contribution rate only to that part of earnings higher than a minimum level;
- ☐ a basic allowance, i.e. applying the contribution rate to the whole of the earnings, but crediting the employer with a contribution corresponding to that part of earnings below the "floor";
- ☐ a flat-rate reduction, i.e. reducing the contribution by a flat-rate sum per employee.

These measures would introduce a certain degree of progression into the effective contribution rates; they thus constitute the inverse of an earnings ceiling applied to contributions. For example, given weekly earnings (in Belgium), a contribution rate of 30 %, a "floor" or lower earnings limit of 1,000 Belgian francs (or a flat-rate reduction of 300 Belgian francs), the following picture emerges:

Earnings per week (Belgian francs)	Contribution base	Effective contribution	Reduction	Effective contribution rate
4000	3000	900	- 300	22.5 %
10000	9000	2700	- 300	27.0 %
15000	14000	4200	- 300	28.0 %

The advantages of such an exoneration scheme are:

- ☐ There is a decrease in contributions for firms paying relatively low earnings. The proposed scheme introduces in effect a certain degree of progression into effective contribution rates. But transfers of costs between firms remain relatively limited, and a very high increase for certain firms considered individually is excluded.
- ☐ Employment is encouraged, because the volume of the decrease in contributions is determined by the number of jobs. There is therefore an incentive to take on extra employees (more advantageous than overtime working) as well as to take on part-time workers.
- ☐ These measures, though encouraging employment, do not penalize firms which invest.
- ☐ These measures are easy to apply from the administrative point of view. They do not create any threshold or frontier effects. From a policy point of view, they provide a further instrument (a "floor") in addition to the contribution rate, one which would be relatively easy to manipulate.

In the longer term we should aim at a "fiscalization" of those social security schemes where the link with labour has disappeared, i.e. primarily family allowances and health care, and perhaps basic pensions. Such an operation would transfer social levies from firms to households. This has two advantages:

- ☐ Several econometric simulations show positive effects, especially on exports and employment.
- ☐ It also leads to a rationalization of social security financing, i.e. the restoration of a logical link between financing method (insurance or solidarity) and the aims and coverage of the schemes. The benefits corresponding to a professional risk and aiming at substituting income can logically be financed by wages-related contributions. In the case of benefits that guarantee a certain welfare level for the whole of the population, without any reference to a labour situation, national solidarity in the form of financing via taxation is to be preferred.

Fiscalization of the pension scheme also comes to grips with the fear that current wage contributions are no longer a secure financing source, given the ageing of the population and the technological evolution. This does not mean that all increases in social levies would become unnecessary; but, unlike now, they would no longer weigh upon the process of production itself, but on the revenues earned in that process.

The taxes to be increased depend on the tax structure in each country; in most countries with already high personal income taxation, an increase of VAT would be the most suitable. Preference should be given to those taxes with the smallest risk of pushing up production costs.

A successful combination of a flat-rate reduction in employer contributions for each employed person, and a fiscalization through indirect taxes (VAT) is the Belgian "Operation MARIBEL" (1982). A similar measure was taken in Italy in 1977. Its economic results (often compared with those of a devaluation) are usually evaluated as positive, especially with regard to the growth of exports and to the limited inflationary effects due to the increase of VAT rates.

Meanwhile, it should not be forgotten that social security's prior objective is not to stimulate the economy. It would be undesirable to let its function as an instrument for economic recovery dominate over its genuine principles and objectives. Nor can economic or financial miracles be expected from a mere redistribution of social levies between firms or between firms and households.