

# The Fiscalization of Child Benefits

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**Abstract.** The distortions of the Czech public pensions are seducing to treat pension contributions as if they were an income tax. This includes the proposal of the Pensions Commission to differentiate the pension contribution rates according to the number of dependent children. Its proponents ask to finance the opportunity costs of raising children by these tax rebates. Such extreme requirements do not fit in the typical conservative social model, let alone any other family policy models. In comparison with this background, the Commission's proposal is very modest. A simple and effective child benefits reform involves a shift to substantially higher and universal benefits that would bring even more to the respective party's electorate. The further fiscalization of Czech child benefits is ineffective. Czech and international experience has shown that Czech child benefits can be effectively provided both by the social administration and the tax administration.

**Keywords:** child benefit, tax expenditure, tax rebate, public administration, pension contributions

**JEL Classification:** H24, H55, H53

## Introduction

The fiscalization of child benefits means a shift to the use of the tax system, especially the income tax, to support families with children instead of direct public benefits. In some countries, this fiscalization has occurred under the influence of social policies promoting workfare (work for welfare): the recipients of social benefits are supposed to "work off" these benefits with gainful activities, if possible, or with community service. In this regard, it is often emphasised that tax expenditures have their own logic: this involves "make work pay" tax expenditures (OECD, 2010).

The fiscalization of child benefits in OECD countries in past decades is a fact but the question remains as to whether this does not merely involve a new disguise for the post-war policy of low-income targeting and selectivity in the area of child benefits (Ferrarini et al., 2012). We investigate the extent to which it is possible to explain the fiscalization of child benefits using the theory of welfare regimes. The aim of the paper is to analyse the developments in this context and especially the current status of child benefits in the Czech Republic and the proposal for the introduction of tax rebates; we will also mention the current problems associated with the administration of child tax credits. We use a graphic analysis of the influence of the separate benefits on the total amount of this support. On this basis we also submit a proposal for the rationalization of child benefits.

Child tax allowances (deductions from the income tax base), introduced by the Czech tax reform of 1993, were replaced with refundable tax credits from 2005. The differentiation of tax credits according to the number of dependent children was introduced in 2015. Child allowance was universal up to 1995, income-tested since 1996 and differentiated according to the age of children since 2008. Families with income up to a multiple of 2.4 of the family existence minimum are entitled to the child allowances. Nowadays about 90% of children are entitled to the child allowance; its amount is about half in comparison with the child tax credit.

The Pensions Commission has proposed to increase the (basic) rate of the pension insurance contribution by 1% of the wage, the rate shall remain unchanged for insured individuals with one child (a rebate of 1% in comparison with the new basic rate): the rebate for 2 children is 2.5% of the wage, for 3 children it is 5% and for 4 or more children it is 7.5%. This applies to both parents, provided they both pay contributions for pension insurance. This proposal is a modest variant of the Christian-Democratic Party's program (a 3% wage rebate for each child, for both parents). The aim of the proposal is the reduced taxation of families, especially of those with higher earnings. We analyse the Commission's proposal in the context of the family policy social models and we especially show its impacts on the overall fiscal support for families with children in relation to their earnings.

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## Child benefits social models

We may distinguish several family policy welfare regimes (social models) in the OECD countries (Thévenon, 2011; Schleutker, 2014). Classic liberals consider the birth and upbringing of children to be an exclusively private matter where the state should not intervene; these liberals only acknowledge general social assistance for those who are unable to take care of themselves. Modern liberals (for example, Beveridge) recommend universal benefits for children at the subsistence level along with the presumed existence of progressive income taxation.

Neoliberals push through income tax credits for low-income families only. The neoliberal social model can be illustrated by the Earned Income Tax Credit in the USA, where the credit is zero if the family income is zero, it quickly rises with increasing earnings up to the “break-even point” where the tax credit is independent of earnings and then it relatively quickly falls back down to zero. Some countries combine two approaches: universal child benefits and tax credits for low-income families. In our country, we have been left with an unfortunate combination of these benefits by our (neo)liberal governments: child benefits are income-tested and tax credits are universal.

Conservatives have always sponsored family promotion, including the classic division of labour in the family. The conservative income tax model respects the ability to pay of families, the optimum solution is a progressive tax on the family income with allowances for the taxpayer and the family members; the family subsistence level may not be taxed. The alternative is a (progressive) taxation of family income per capita. Nowadays, conservatives also acknowledge child benefits as a supplement, a replacement for the deductible from the income tax base. According to a ruling of the German Constitutional Court, the tax exemption of a child’s subsistence level can also be realised in the form of child allowance; at the same time, however, support for families with children only represents part of the child allowance which exceeds the deductible (Lenze, 2008). Income-tested child benefits are used in a number of countries of this type.

Social democrats emphasise equal chances for everybody, irrespective of family and market; they prefer the dual-earner model. Social democratic social policy supports relatively high, universal child allowances and rejects tax expenditures of any type. The provision of public services for families with children for free or for a small fee is more important in this model than pecuniary benefits. Income tax is progressive. A number of the elements of social democratic family policy have also been adopted by “conservative” France and Germany.

The four child benefit social models are depicted in Figure 1. Two classification criteria are applied here: one is the universality in contrast to the selectivity/targeting. The other is the lower or higher generosity of these benefits. The social democratic and (modern) liberal models “make do” with one benefit: universal child allowance. The neoliberal model is also associated with one benefit: an income tax credit for low-income families. The conservative model uses income tax (deductibles or splitting); eventual universal child allowance is also derived from the tax theory.

**Figure 1: Typology of social models of child benefits**

	<i>Lower generosity</i>		
<i>Selectivity/targeting</i>	Neoliberal model	Liberal model	<i>Universality</i>
	Conservative model	Social-democratic model	
	<i>Higher generosity</i>		

Source: author.

Refundable tax credits might be taken as a compromise between social democratic and conservative social models; much mainly depends on the basic condition for the entitlement to the tax credit: the credit may be subject to tax residency only (i. e. income may be zero, too). Refundable tax credits and child allowances may only differ in the public administration: whether they are administered by the tax administration or the social security administration. Tax credits are, of course, usually income-tested throughout the world (Ferranini et al., 2012).

Nowadays, the tax rebate exists in Germany only, to a merely symbolic extent: in the social long-term care insurance: insured individuals without children pay a 0.25% p. p. higher premium rate. A tax rebate might be a tool of social policy in the conservative model and its practical non-use can be explained by its distinct preference for higher income groups.

Non income-related child benefit is still the most popular vehicle for delivering the child benefit package. Only 7 (out of 22) countries do not have any non income-related child benefits. 13 countries have income-related child

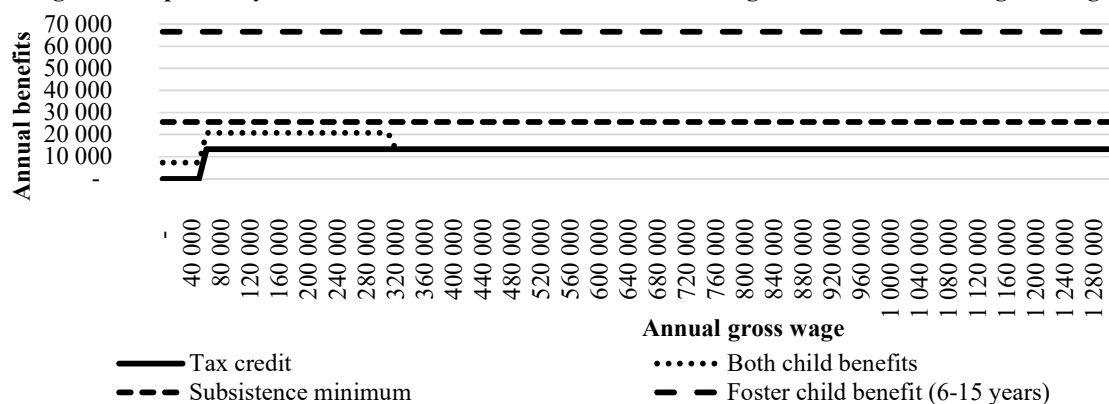
benefits or social assistance for employed families. The main shift has been towards using the income tax system to distribute resources to families with children. Out of all 22 countries only Austria, Denmark, Finland, Ireland, Israel, Norway, Portugal and Sweden have no recognition of the needs of children in their income tax arrangements (Bradshaw and Finch, 2002). The fiscalization of child benefits therefore did occur in the previous period, nevertheless the universal child allowances are still the generally most significant benefit.

## Czech child benefits and family incomes

The Czech mix of universal child tax credits and income-tested child allowances does not belong to any of the social model of child benefits. It is a mixture of three models: the social democratic, conservative and neoliberal models. We have child allowances, but they are rather low and income-tested. We also have tax credits but with a minimum earnings threshold. On top of that, unemployed pensioners are not eligible for the tax credit for raising children. In a four-member family type with one breadwinner and two children aged 2 and 7 years, the sum of child allowances and tax credits in our country amounts to 20% of the net average wage in industry (Turková, 2014). State support of this family type is the highest one in an international comparison with 18 OECD countries (Ferrarini et al., 2012). At the same time, however, these two benefits for the children aged 2 and 7 amount to a total of 3,544 CZK per month which is less than the official Czech subsistence minimum level for these two children in a family (3,880 CZK per month). This is the Czech reality with which we may but need not be satisfied: this depends on the concept of the entire social policy, which citizens, parties or the government proceed from.

The general costs for children are significantly higher than the official Czech subsistence minimum for them. Supporters of the differentiation of insurance premiums based on the number of dependent children had argued that the costs for children are significantly higher in families with higher earnings and they had required some sort of compensation for the opportunity costs brought about by caring for children. The fundamental political question is, however, whether the state support for children should be directly proportional to the earnings of the parents or whether it should be uniform for all children (universal) or whether it should be indirectly proportional (higher support for low-income families). Targeted support for families with higher or high earnings does not fall under any social model: this can be considered to be antisocial from the point of view of all the models. The higher amounts of the tax allowances for taxpayers with higher incomes in conservative systems are in fact based on the expected progressiveness of the income tax rates.

**Figure 2: Dependency of a tax credit and an allowance for 1 child aged 6-15 on the annual gross wage**



Source: author.

We show the annual state support for families with children in the Czech Republic using a family with one child aged 6 to 15 in Figure 2 under the conditions in 2015. The child tax credit (13,404 CZK) is independent of the wage (from half of the minimum wage upwards). In the case of lower-income family, this benefit is supplemented with an allowance of 7,320 CZK. We have also added the subsistence minimum for one child (25,680 CZK) and the allowance to cover the needs of a child aged 6-12 in the foster care (66,600 CZK), which can be considered to constitute the theoretical maximum which the state is prepared to pay for the individual child care, alongside the child allowance and child tax credit; the foster parent also receives a remuneration.

The current level of state support for families with 4 children aged 6-15 is slightly higher: even here, the sum of the tax credits and allowances does not reach the subsistence minimum for four children at the amount of 102,720 CZK. In the case of families entitled to child allowances, the “gap” between these two amounts here is 10,224 CZK per year.

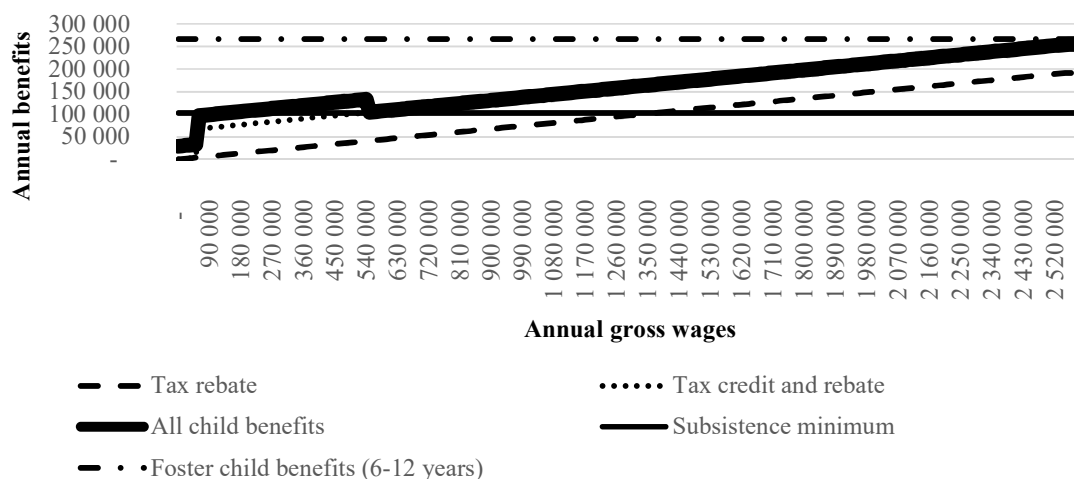
## Child benefits reform proposals

The rebate on pension insurance contributions proposed by the Commission has a fully different concept than the child allowance or tax credit. The tax rebate is scheduled for both parents, provided they are insurance contribution payers, the rebate is capped by an earnings ceiling valid for insurance contributions (currently 400% from the national average gross wage).

The proposed rebate on insurance contributions is but a mere fraction of the tax credit for the absolute majority of families with one child. The rebate comes out at less the half the tax credit for the majority of families with one child. The highest possible rebate is 2,129 CZK, i.e. 1.9 multiple of the tax credit and also 99.5% of the child's subsistence minimum. The preferential treatment of parents with high earnings is apparent, however it can be postulated that the mentioned state support is essentially of little interest to such parents.

Figure 3 shows the benefit presented by the rebate for families with four children under the conditions of 2015: the annual gross wage stated here is the sum of the earnings of both parents. In this case, the rebate is a mere fragment of the tax credit for the majority of families, too. Both of these types of state support are of the same amount, if the parents earn a total of 70,240 CZK. We expect that the rebate will not provide motivation to raise more children even in the exceptional cases of families with high earnings.

**Figure 3: Dependency of a tax rebate, a tax credit and an allowance for 4 children aged 6-15 on the annual gross wages of both parents**



Source: author.

The proposal to introduce the differentiation of the pension insurance contributions is a de facto proposal to increase the income taxation of those insureds who are not raising any children. Under the existing Czech conditions, the paid insurance contributions bear no relation to the provided pensions and as such they constitute receipt for the state budget just like income tax or value added tax.

The child tax credit is usually justified in our country as a motivation towards gainful employment. Mazars (2014) considers child tax credits to be one of the most effective forms of financial assistance because they motivate people to find a job, their administration is undemanding and the income is not tested. "The non-socialist alternative to the government concept for family policy" (Občanský institut, 2005) is more thorough in its conclusions than Mazars: it requires the transformation of child allowances into tax credits. According to this concept, family support in the form of a tax credit "increases the awareness of economic autonomy and eliminates the feeling of the dependency of families on the social security system. At the same time, it also reduces any difficulties associated with the redistribution ... within the ... the state budget. The amount of the tax support for families should be dependent upon the families' income situation, because this involves a tool of horizontal solidarity between childless people and families." The existence of the child allowance stops making sense due to the fact that the tax credit is provided in the form of a uniform contribution. In the case of those individuals who are not gainfully employed, the function of securing the subsistence minimum for dependent children is assumed by the social assistance pillar. According to this concept, the tax credit should be increased to the subsistence minimum (Občanský institut, 2005). This "non-socialist" concept for child benefits has thought them to the end – with one exception: it ignores unemployed pensioners with dependent children.

A fundamental question is, how the universal tax credit differs virtually from the universal child allowance. We must, of course, take into account the Czech precondition of minimal gainful activities (at the extent of half the minimum wage), which fits the neoliberal model, albeit that universal tax credits do not fit into this model. Moreover, the Czech precondition of minimal gainful activities is of little practical significance from a purely economic point of view because families with no income are entitled to a social assistance benefit which respects the subsistence minimum for these children.

All that therefore remains of the arguments used against universal child allowances and in favour of universal tax credits is the problem of the administrative demands. According to this argument, an advantage of tax credits lies in the fact that it saves the “isolated” agenda of child allowances, which are administered by the Labour Office in our country. In the case of tax credits for employees, it is “sufficient” to take the child’s birth certificate to the company’s personnel department. However, a modern public administration should not distinguish between universal child allowances for all children and the benefits constructed in the same way, but hidden in the income tax. Throughout the history of Czechoslovakia, child allowances were sickness insurance benefits paid out by personnel departments ... and there may also be something similar from a technical point of view today. Universal child allowances may be administered by the public tax administration, just like universal child tax credits. For example, Australia, Canada and New Zealand have tax benefits that can be paid directly (Bradshaw and Finch, 2002). Given the identical structure of benefits, the essential thing is effectiveness, including tackling fraud in this area.

In 2015, the Czech Ministry of Finance discovered that negative income taxation due to refundable child tax credits was being abused; the tax administration has now created a system of records of dependent children. Recent discussions have confirmed that the Czech debates about tax benefits and child allowances have only been built on convictions and general impressions. On the other hand, “international evidence is compelling in showing that universal benefits, alongside a broad range of universal services, deliver the best supports for all the children... No one has ever identified any labour market disincentive effects or poverty traps” (Harvey, 2014).

The simplest rationalisation of the current two Czech child benefits is to merge them into one universal benefit. In the case of one child aged 6-15, the sum of these two benefits amounts to 1,927 CZK per month. Even with regard to the political interests associated with the proposed introduction of a tax rebate, we do not expect that there will be any targeting of this merged child allowance. For the same reasons, it is possible to consider increasing this benefit to the subsistence minimum in the 6-15 age group which represents 8.04% of general assessment base in pension insurance. A universal child allowance at this level is lower than the basic (universal) amount of the Czech pensions, parametrised at the level of 9% of the same assessment base. This expresses the preference for meeting the needs of senior citizens over children, which is typical for an entire range of countries and can be explained by the relative importance of senior citizens at the ballot box.

Figure 2 shows that the introduction of a universal child allowance at the amount of the subsistence minimum would mean an increase in the income of families with one child, usually by 413 CZK per month. In comparison with the proposed tax rebate, the universal child allowance is more advantageous given family earnings up to about 97,500 CZK per month, which represents two wages at the level of about 1.8 multiple of the national average. At the cut-off point where the entitlement to the current income-tested child allowance ends the proposed universal child allowance should only be advantageous by about 155 CZK per month.

The introduction of a universal child allowance at the subsistence minimum level instead of two benefits would also be advantageous for families with 4 children. The proposed tax rebate would be more advantageous (in comparison with the universal child allowance at the amount of the subsistence level for 4 children) from a total parents’ income of about 39,200 CZK per month. However, this would not have to be “detrimental”, as there are foreign practices topping up the universal child allowances with benefits for larger families or differentiating the universal child allowance according to the number of children. The counterproposal to the differentiation of the insurance contributions according to the number of children could therefore be the introduction of universal child benefits at least at the subsistence minimum level, for example, instead of the existing income-tested child allowances and the child tax credits.

## Conclusions

The Czech state support for families with children is not rational. It is possible to simply increase the effectiveness of the child allowances and tax credits. Using experience gained from abroad, it is particularly possible to recommend universal child allowances set at the level of the subsistence minimum. This system could be effectively monitored not only by the social security administration, but also by the tax administration. This would also mean more money for most families with higher incomes which the Pensions Commission has targeted with its proposal to introduce rebates on pension insurance contributions. The main advantage for individuals and families with higher and high incomes in our country is the non-existence of the progression of the income tax

rates, in comparison with western countries. The proposal for the introduction of rebates on pension insurance contributions is an attempt to weed out an otherwise bad system of state financial support for families with children.

The advantage of universal child allowances over tax credits is currently also the fact that their realisation does not require the introduction of the taxation of pensions; the cancellation of child tax credits would immediately remove the discrimination against pensioners in relation to the income tax credit. Universal child allowances fully conform to the social democratic and liberal social models, so it should be relatively easy to push the proposed reforms through the current government. The “hankering after” the conservative social model, which takes greater account of families with higher earnings, is admittedly understandable but for all that the basic variant for the realisation of this model using tax deductions does not make sense under Czech conditions because there is no flat income tax rate. The conservatively oriented section of the Czech political spectrum could mention that, for example, Germany has significantly shifted towards the social democratic model in this respect.

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