

Reform of the Regulations on Marginal Employment Lacks Cohesion

During the campaigning for the recent general election in Germany, almost all parties promised measures to prevent the 'abuse' of marginal employment, also called 620-Mark jobs. These are jobs below the ceiling on monthly earnings before social insurance contributions become due and which involve less than 15 hours per week to be worked. Up to 1998 the income ceiling was DM 620 in west Germany and DM 520 in east Germany, from April 1999 onwards the ceiling will be raised to DM 630 for west and east Germany.

When the legal status of 'marginal employment' was introduced some decades ago, government had assumed that it would consist purely of supplementary employment, and would not be used as a permanent source of income. For this reason such jobs were not made subject to compulsory social insurance contributions, and personal income tax need not be paid, provided the employer makes a 'flat-rate' tax payment of 20% of earnings to the tax office. Most married marginal employees would otherwise have to pay income tax at a higher rate. This makes marginal work attractive to many married women. Employers, too, often like marginal employment relations, because they are not obliged to pay social security contributions and labour can be deployed more flexibly than under regular employment contracts. Given that there are now 5.5 million marginal employees in Germany, it can no longer be presumed that these jobs are of only 'marginal' importance for the labour market. It was against this background that all political parties promised reforms, without, however, specifying the details.

The new government has now presented a reform concept for marginal employment that is not worthy of that name. Of all the goals discussed in connection with such a reform, the only one it will achieve is to slightly raise revenue for the social insurance funds. Yet the fundamental problem remains the 'wall' between marginal employment and regular part-time employment subject to social insurers contributions, a problem the government has not even begun to address.

Background to the reform

In recent years 'marginal employees' have increased to around 13% of total employment in west Germany. This form of employment is practised by about 10% of those

working in east Germany. The trade unions and many politicians have concluded from this that full-time jobs are being 'split up' into marginal employment relations in order to avoid shouldering the cost of social security. Yet this fear is only partly justified. The increase in the marginal employment has been associated with a structural change in favour of services, which require flexible operating or opening times. In other words, full-time jobs in industry have been lost, while marginal employment relations in the service sector have been created. In large industrial enterprises shift work for full-time employees has been the traditional way to create flexibility at enterprise level; such models are impractical, however, in small service companies.

Jobs with a small number of weekly working hours are therefore a manifestation of fundamental changes on the labour market. Employers and certain groups of workers have an interest in such flexibility. In Germany, this flexibility potential tends to take the form of marginal jobs because of the existence of specific incentives. For those concerned, this form of employment entails little administrative costs because social security contributions need not be paid and the employer makes a flat-rate contribution to wage tax.

Many employers may also be attracted by the likelihood that marginal employees often refrain from claiming the rights to which they are entitled as employees (e.g. collectively agreed wage rates and dismissal protection) because they consider themselves 'second-class workers' as they do not possess a wage tax card.

Pensioners, students and married women are often keen to work without paying social insurance contributions because they are already insured by other means under the social protection system, or at least believe themselves to be covered. Married women frequently underestimate the risks invoked in refraining from building up an autonomous entitlement to benefits in old-age that can result from divorce or the premature death of their husband.

The fact that marginal jobs are not subject to social security contributions leads not only to the loss of social insurance revenue that has been the focus of much of the debate, but also to a number of inconsistencies within the social security systems:

- Most marginal employees are already insured as a member of the family of an insured employee, or, as students and pensioners, are already covered by health insurance. It cannot be justified that such people, who enjoy full health insurance cover, should not contribute to financing the health system by contributing the usual proportion of their earned income.
- In the case of social security in old-age, the same consideration applies to marginal employees insured by

virtue of marriage; they are entitled to a dependent survivor's pension, but do not contribute by paying a fair share of their income.

- In the case of the other marginal employees, especially single mothers and those whose employment tends to be discontinuous (in particular young graduates), it would be beneficial if they were able to earn an entitlement to a pension; this is not possible, however, as marginal jobs are not subject to social insurance contributions.
- In distributional terms it cannot be justified that those with a second job that is marginal pay neither social insurance contributions nor individual income tax on this additional earnings.

To some extent the positive view of marginal jobs held by employees is based on the illusion that such activities are tax- and contribution-free. However, many employers pay a flat-rate income tax, the cost of which, at the end of the day, they do not bear themselves, but largely pass on by paying marginal employees lower hourly wages than socially insured employees. As a result single marginal workers could be at a disadvantage, as if their income was assessed for tax purposes on an individual basis they would effectively pay no income tax, as their taxable income would be below subsistence level.

The central problem is that the 'marginal ceiling' at DM 630 per month constitutes a 'wall'. Persons earning just one D-Mark more, or working slightly more than 14 hours per week are subject to compulsory social insurance contributions and wage tax; this can only be avoided by those in discontinuous employment, which, however, leads to a loss of rights such as dismissal protection. Beyond this wall the employer loses the advantage of low administrative costs, while for the employee the marginal tax and contribution burden is extremely high. It is therefore hardly surprising that very few people in Germany work between 15 and 18 hours a week. This wall is also responsible for the fact that far more than one in ten employed persons works less than 15 hours per week; this has nothing at all to do with genuine labour market flexibility. In the USA, the flexibility of whose labour market is seen by many as exemplary, just 5% of the labour force work less than 15 hours per week.¹

Reform goals and concepts

A large number of – to some extent contradictory – expectations are held of a reform of the regulations on marginal employment:

¹ Figures derived from the German Socio-economic Panel Study (GSOEP) and the Current Population Survey (CPS) of the USA.

- Many workers wish to retain the – supposed – exemption from taxation and contributions.
- Other workers want to earn social insurance entitlements, in particular to old-age pension benefits.
- The social insurance institutions and the government want to generate additional revenue for the health and pension funds by widening the coverage of compulsory social insurance.
- Workers, the trade unions, employers and many politicians neither want to destroy jobs nor prevent the creation of new jobs, but they do want to prevent the abuse of the existing regulations on marginal employment by making this form of work less attractive.

Looking at this list, it is readily apparent that no reform concept is going to be simple. Moreover, the distributional problems associated with the flat-rate tax also need to be considered.

All the above problems would disappear only, if social security provision were decoupled completely from paid employment. Individual social provision can be attained either by means of a basic social provision financed out of taxation and not based on personal contributions, or by making all adults subject to insurance contributions ('national insurance' as envisaged by the later Lord Beveridge).²

Given that such sweeping reforms do not appear feasible at present, second-best solutions must be considered. What realistic options are there for a reform of marginal employment, and what view is to be taken of the new regulations planned by the new German government?

Any reform concept for marginal employment must distinguish between two problem areas, social insurance and taxation.³ It must be borne in mind that 'indirect' labour costs, such as employer social insurance contributions and flat-rate taxes paid by the employer, can be offset by lower wages. This is likely to be particularly easy in the case of many marginal employment relations as trade union density in this area is very low.

Depending on whether one leans more towards a tax-financed basic provision or a 'national insurance', two very different reform strategies suggest themselves:

- Those in favour of a tax-financed system offering basic provision can argue for an upward extension of the income ceiling for exemption from social insurance contributions. A proposal on these lines

² Sir William Beveridge, *Insurance for All and Everything*, London 1924.

³ Until the German government announced its concept, the debate on this issue had excluded the possibility that both the flat-rate tax and individual income tax would be dropped and marginal employees would, in principle, be exempt from taxation.

has been made by the Munich professor Bernd Huber; it has not yet been taken up by the political debate. This is not surprising as a pure system of basic provision currently stands no chance of attracting majority support in Germany.

- Proponents of a 'national insurance system' must argue logically for the abolition of the exemption from social insurance contributions for marginal workers (or its reduction to a very low level).⁴

According to the coalition agreement, which sets out the medium-term programme of the new German government, it is the government's intention to introduce compulsory insurance for all forms of paid employment; this represents a strategy on the 'national insurance' model. Within such an approach it would be logical to abolish the exemption for marginal employees not only with respect to social insurance, but also to income tax, as in the case of USA or Switzerland, for instance. From the employers' point of view, labour costs would remain virtually unchanged; the obligation to pay social insurance contributions would, however, lead to higher administrative expense.

In order to minimise such transaction costs, all of the reform concepts under discussion envisage that fixed-term auxiliary activities ('on call relations') be exempted from compulsory social insurance contributions, and that the option of paying a flat-rate tax be retained in such cases. However, this would establish an incentive to establish 'on call relations' and abuse the system; this can only be avoided by introducing individual compulsory insurance or a tax-financed basic welfare provision.

The abolition of flat-rate taxation, which logically implies that employees would become individually responsible for paying tax on any income earned in marginal employment, would remove the serious drawbacks of the current regulations: the flat rate of tax benefits those marginal employees who are assessed together with a spouse earning average or above-average income, because the marginal rate of tax for these couples is greater than 20%; in addition, the regulation privileges in tax terms those holding two jobs.

Evaluating the government concept

Under the concept proposed by the government, employers will have to pay pension and health insurance contributions for 'permanent' marginal employees; these will not, however, generate individual benefit entitlements.⁵

⁴ It is accepted even by proponents of the other reform model (such as Bernd Huber) that this would also solve the problem of the 'marginal employment trap'.

In order to prevent labour costs rising significantly, the flat rate of tax is to be abolished. At the same time, an increase in the tax burden on married couples and those with two jobs is to be avoided, as income from marginal employment is not to be subjected to individual income tax.⁶ This means that the 'wall' of marginal employment remains completely intact: those earning more than the ceiling and/or working longer than 14 hours a week face a sharp rise in the burden of employee social insurance contributions and tax payments.

Given that as of 1999 the income ceiling has been frozen at DM 630, the attractiveness of this form of employment for employees is likely to decline as wages and prices rise. The decision to freeze this income ceiling suggests that, in principle at least, the government believes that marginal employment relations should be subject to social insurance contributions in full. Given the moderate rates of inflation expected, however, it will take decades for this aim to be realised by this means.

In order to restrict the abuse of marginal employment, for example by holding several such employment relations, in future each marginal employment relationship is to be recorded on the individual's wage-tax card; moreover, the payment of employer social insurance contributions enables the social insurance institutions to monitor abuse effectively.

The second-class nature of marginal employment relations with respect to collective agreements and the respect of employee rights can be expected to improve somewhat under these new regulations, as recording such a relationship on the worker's wage-tax card will make it clear to workers that even marginal employment is a genuine employment relationship. Whether this has a telling effect, on the other hand, will depend on the behaviour of trade unions and workers councils, and in particular on the definition of 'permanent' employment. In the catering industry and other services, for example, it is not easy to determine when an employment relationship based on work 'on call' to meet demand peaks is to be considered permanent.

There must be concern that the new regulations will mean that fewer and fewer marginal employees will be treated as 'permanent employees'. As a result, any increases in contribution receipts by the statutory health and pension insurance schemes are likely to remain

⁵ Entitlements can be earned, however, if the employee is willing to top up the contributions by making payments equivalent to 7.5% of the wage.

⁶ This solution is a lesson in public choice theory. Whereas social insurance contributions benefit central government directly, it loses only a proportion of its tax revenues, as it is obliged to share them with state governments. Thus central government would have gained an advantage to the detriment of a third party if state governments had accepted this change without compensatory payments.

modest. According to the results of the DIW's 'German Socioeconomic Panel' (GSOEP), only around 50% of all marginal employees work in marginal employment relationships for more than six months per year. This represents around 2.5 million marginal workers, of which, in turn, a significant proportion work in private households. By considering themselves as self-employed service providers they avoid paying contributions. Assuming that 1.8 million permanent marginal employees are active in the business sector and that on average they earn DM 500 per month, this would generate an additional DM 1.3 billion in annual contributions to the statutory pension insurance scheme and DM 1.1 billion per year for the health insurance funds per annum. This represents around 0.4% of contribution receipts by the pension funds and about 0.5% in the statutory health insurance scheme. Really substantial additional receipts would only be generated if the insurance obligation was based on the individual and not on the place of work, and by this means incorporated those working in private households and the self-employed not currently paying contributions.

Individualised reporting to the social insurance funds means that the new regulations will at least shed light on the real extent of permanent marginal employment. This will then also reveal the proportion of marginal employment that must be considered part of the shadow economy.

It is often claimed that the payment of social insurance contributions by marginal employees that are not balanced by individual entitlements is contrary to the German constitution. However, a similar case has existed for many years. Those aged 65 and over and drawing a state pension can earn as much as they want on top of their pension. If they exceed the ceiling on marginal employment, the employer must pay contributions, but they have no impact on the pension level.

It seems far more plausible to argue that it is against the constitution to refrain entirely from taxing a certain form of earned income. Government supporters have argued that the tax exemption for marginal employees is a step towards a 'combined wage model' (i.e. a mixture of earned and transfer income) in favour of long-term unemployed. While this may be correct in principle, it poses the question as to the distributional legitimacy of such an instrument and whether it will help to promote the recruitment of the unemployed. In this context it must be borne in mind that the current subsidy – namely the exemption from social insurance contributions for marginal workers – has not led to such employment relationship being offered to the long-term unemployed as an exit path out of unemployment. The vast majority of marginal employment relationships – more than 90% in fact – are performed by pupils and univer-

sity students, pensioners, housewives, single parents and by persons with another (main) job. A combination of wages and benefits for the long-term unemployed may be a sensible measure, but it must be such that the long-term unemployed are not given an incentive to work in the marginal employment segment, where the opportunities for further training are extremely limited.

Conclusion

If the federal government is concerned to avoid restricting labour market dynamics in the low-income segment, it should seek a solution that tears down the 'wall' represented by the ceiling on marginal employment. This is not achieved by the envisaged reform concept.

In fact the way forward was set out in the new government's coalition agreement. There the government's intention is expressed to incorporate all forms of paid employment, i.e. including self-employed activities, into the social insurance system. This would tear down the wall consisting of a high marginal tax and contribution burden that still blocks the transition from marginal work to regular part-time employment. Yet this would also require the courage to abolish flat-rate taxation in favour of an extension of individual income taxation. It seems that such a reform – as is the case with a comprehensive concept for a re-regulation of the labour market and a reform of social security – cannot be implemented in the short run. Consequently, the reform of marginal employment should be placed on the agenda of the 'Alliance for Jobs': these tripartite talks between employers, unions and the government, that are to be chaired by the Chancellor personally, should serve not only to bring about a reduction in German unemployment in the short-term, but also to find new, sustainable regulations for the labour market and social security. One advantage, at least, of the proposed reform of marginal employment is that it is in fact so marginal that it will not constitute an obstacle to a more comprehensive reform.

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