Introducing child benefits in pension systems: rationale, pros and cons

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Child benefits are never explicitly included in pension systems, although mothers often receive other forms of compensation, such as provisions for earlier retirement or higher pensions. There are good reasons to reconsider this choice: Gustavo De Santis discusses the pros and cons of such a reform.

Before the invention of pension systems, at the end of the 19th century, the idea of "sponging off society", and being morally entitled to do so, was simply non-existent. Nowadays, instead, in all developed nations and in a growing part of the developing world, this is almost taken for granted: "I did what I had to do when I was an adult. Now that I am too old to work, it is only fair that society should support me in return for my past contribution to its prosperity". This mode of reasoning also highlights the shrinking role of the family in supporting its oldest members, a void progressively filled by the state.

The same line of reasoning could easily be applied to children: "I am too young to work now, but I need resources. I can borrow them from society, and repay my debt later, when I am old enough to start working for the market". In this case, more so than for the others (older people), the family is still there, of course, but the state is already progressively (and ever more massively) stepping in. Indeed, child transfers already exist in virtually all societies, but they are not explicitly included in pension systems (which, if transformed in this way, should probably be relabelled "intergenerational transfer systems", or something of the kind). Their purpose is two-fold: first, societies want to make sure that children are properly looked after (receive medical attention, go to school, etc.) and, second, societies wish to alleviate the cost of raising children, which is particularly high in a context where children cannot work before reaching adulthood, cannot be left alone, and must receive adequate education and medical care. Besides, when they are finally in a position to earn some money, children rarely use it to repay their parents but rather to build their own life. On top of that, their parents' pension will normally be provided by the state so the children do not have to worry about their financial welfare.

Not surprisingly, fertility has drastically declined all over the world. Of course, the reasons are much more complex than I can possibly discuss here, but rising costs and declining economic benefits for parents are certainly among the causes. Public subsidies are one of the proposed solutions for addressing this problem. A moderate amount of child benefits within pension systems would simply work towards the same goal: that of sustaining fertility. Incidentally, even ideal pension systems, such as IPAYGO (De Santis 2024a,b), undergo considerable stress if births decline too much: preventing this outcome is in the best interest of pension systems themselves.

The disadvantages of including child benefits in pension systems

The disadvantages of a reform of this type (introducing child benefits in pension systems, with resources taken from payroll contributions) are obvious: as the number of beneficiaries increases (older persons *and* children), either payroll contributions must rise, or pensions must decrease, because a balanced budget is, or at least should be, one of the guiding principles of all pension systems. In the former case working adults have to bear the additional cost; in the latter, pensioners do. And if a compromise is struck between these two extremes (somewhat higher contributions *and* slightly lower pensions), the entire electorate will be worse off in the short run, an outcome which considerably reduces the likelihood of a reform of this type ever being adopted.

The advantages of including child benefits in pension systems

However, there are also a number of advantages. There is, for instance, the pro-fertility argument discussed earlier, which would bring with it some simplification, because other forms of delayed parental support usually embedded in pension systems could then be abolished (e.g. earlier retirement or extra pension benefits). There would also be an implicit redistributive component, from the rich to the poor, if child benefits are flat (same for every child) but contributions proportional to labour income.

Beyond that, two more advantages are particularly worth mentioning. The first is that this arrangement would help to stabilize the required (or equilibrium) payroll contribution rate. When societies grow older, there are more seniors around, but fewer children, and although the positive and negative components of the transfer system would not precisely match each other, at least they would move in such a way as to attenuate oscillations, making the system easier to manage.

The second advantage is that in PAYGO pension systems, a mysterious mechanism is at work, whereby population increases lead to ("quasi capital") gains while population declines create ("quasi capital") losses. As developed countries are facing population declines, or are about to face them, losses are currently much more worrying than gains. One of the causes of these imbalances is the difference between the average ages at receiving and paying transfers. Without child benefit, this difference is in the order of 30 years (if, for instance, contributions are paid at age 40 on average and pensions received at age 70 on average). The formula is not given here (you can find it in De Santis 2024a), but suffice it to say that this age difference enters multiplicatively into the calculation, and therefore has a very strong impact.

Introducing non-trivial child benefits would drastically reduce the average age at receiving transfers and would thereby also reduce this age difference. If this age difference declined to zero, no quasi-capital gains and losses would ever affect the functioning of pension systems, and the “demographic time bomb” would be totally defused. Nobody thinks that we should go that far, but there are strong grounds for arguing that a few steps in that direction could (and perhaps should) be taken.

In my view, these two benefits are strong enough to make it worthwhile to at least start considering the possibility of introducing child benefits in modern PAYGO pension systems. although the majority of readers may not agree.

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References

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