Social Protection
& Public Finance Management

Course on social protection and PFM

Session 8- Domestic Resource Mobilization

This project is funded by the European Union

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The process of policy development

Process

1. Inventory of existing social protection schemes and data
2. Identifying and estimating coverage gaps
3. Costing analysis and projections of financing needs
4. Conducting fiscal space analysis
5. Poverty impact assessment
6. Policy recommendations

How to

- Social dialogue
- Capacity building

Tools

- ABND/SPOTT
- SSI (Social Security Inquiry)
- RAP costing tool
- ILO/HEALTH
- ILO/PENSIONS
- Handbook on fiscal space
- Poverty impact assessment tool

Expected results

- Create confidence and support a national consensus through social dialogue.
- Shared understanding of the national SP system configuration at the country level
- Policy options and costs of extending social protection coverage
- Policy and Financing gaps identification
- Quantification and feasibility analysis of different options to create fiscal space
- Measure impact on poverty ~~linked to~~ of different SP policies
- Strategies for extending social protection (informal sector, women, rural, specific populations)

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Eight financing options that countries should analyse and discuss in national dialogues:

1. **Expansion of coverage of social security and contributory revenue;**
2. **Increase of tax revenue;**
3. Elimination illicit financial flows;
4. Increase efficiency of public expenditure and reallocation to social protection prioritary areas;
5. Use of exceding fiscal and foreign exchange reserves;
6. Debt or restructuration of debt;
7. Adoption of a more flexible macroeconomic frame;
8. Increase of ODA and other forms of foreign aid.

Fiscal space for social protection. A handbook for assessing financing options

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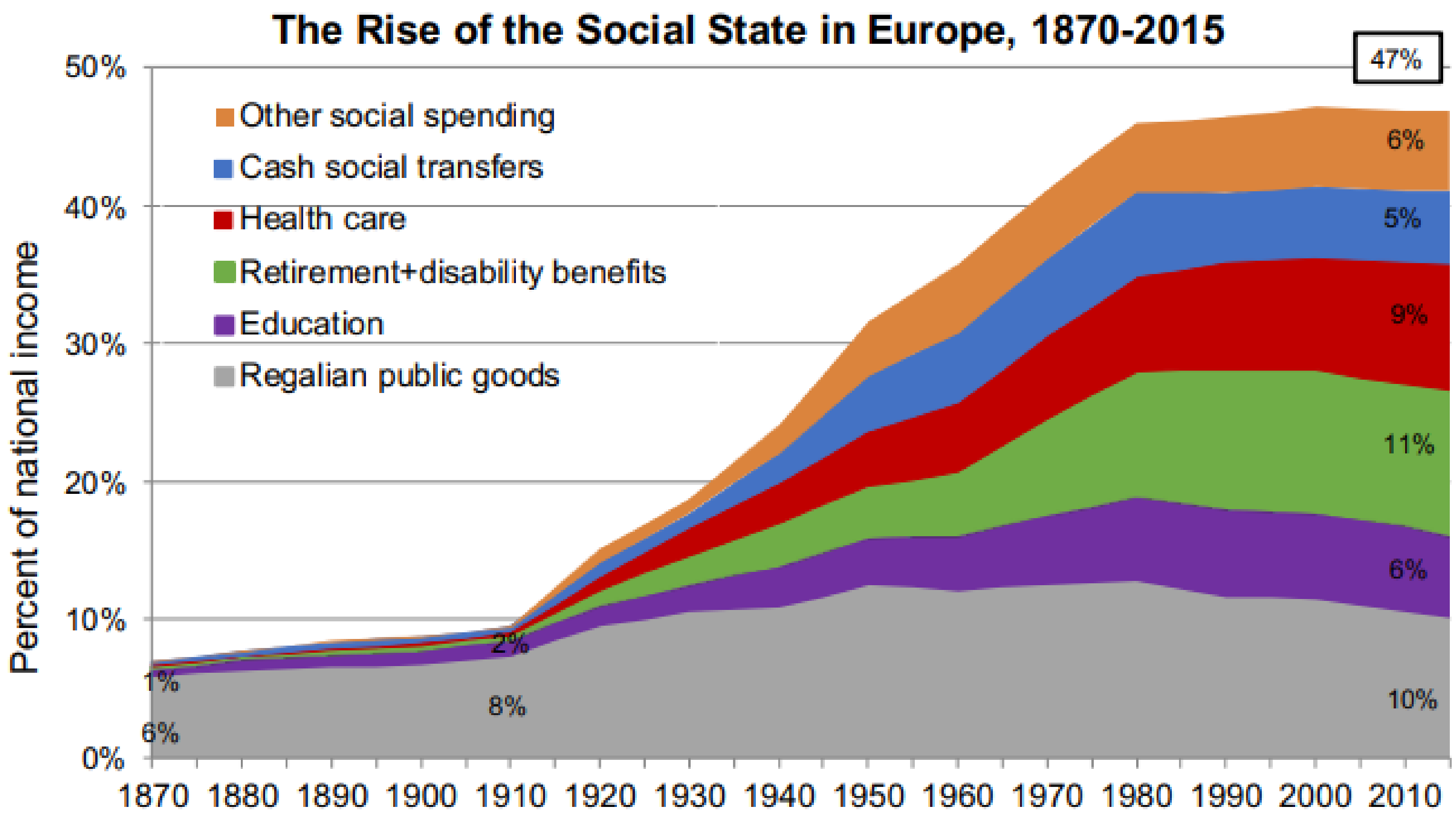
Why Domestic Resource Mobilization for Social Protection?



Source. Piketty (2020, Figure 10.15). Average for Germany, France, Britain and Sweden.
Cash social transfers include unemployment benefits, family benefits, and means-tested benefits.
Other social spending includes in-kind spending such as public housing.
Regalian public goods includes defense, law and order, administration, infrastructure.

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Taxation

Taxation is the main source of public finance and a very stable source relative to other options. Total tax revenues account for more than 80 per cent of total government revenue in about half of the countries in the world – and more than 50 per cent in almost every country.

High-income countries have higher tax-GDP ratio (>20) than lower-income countries (10-20). Income taxes play a greater role in developed than in developing countries, while indirect taxes, e.g. VAT and trade taxes, may be large in absolute terms but are relatively small in more developed countries.

	All	High income: OECD	High income: non OECD	Upper middle income	Lower middle income	Low income
Government revenue (per cent of GDP)	31.1	40.8	34.4	31.6	28.8	20.6
Gov. Revenue excl. Grants (per cent of GDP)	29.4	41.5	32.9	28.2	26.8	17.4
Government taxes (per cent of GDP)	18.8	25.3	17.9	19.0	17.2	13.4
Income Tax (per cent of GDP)	7.2	11.8	6.4	6.2	5.7	4.4
VAT revenue (per cent of GDP)	6.4	6.9	7.5	6.7	5.9	4.4
Trade Tax (per cent of GDP)	2.4	0.2	2.3	2.4	3.5	3.0

Source: IMF, World Revenue Longitudinal Data (WoRLD).

Taxation and fiscal space options

Common types of taxes:

- Income taxes (personal income)
- Corporate income taxes, including taxes on the financial sector
- Property –land- and inheritance taxes. Less common, total wealth taxes.
- Taxing natural resource extraction
- Innovative taxes: Sin taxes (i.e. alcohol, tobacco), airport and hotel taxes, arms and carbon taxes
- Tariffs (imports/exports)
- Consumption and value added taxes (VAT), and tolls

High-income inequality should push governments away from indirect taxes such as consumption/sales and value added tax (VAT), except for VAT on luxury items, and should encourage progressive taxation such as income and corporate taxes as well as property and inheritance taxes.

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The details of taxation

Taxation is notorious for having large changes in its impact according to its detailed description in laws and norms:

- VAT reforms may be about increasing the rate, increasing the taxable base or changing the nature of the tax itself to encourage traceability (e.g moving from sales tax to VAT)
- Personal and corporate income tax effects change depending on local vs worldwide income, on how globalized or fragmented is the treatment of multiple income flows, and especially passive capital gains taxes. Also consider the «small print» of depreciation rules and in general, allowable deductions.
- Wealth taxes are often considered a very difficult to implement tax, because of very high negative elasticity, with the possible exception of land and registered asset taxes. Authors like Piketty that promote more wealth taxes do so with the caveat that it must be international.
- «Sin» taxes are excellent for solving certain negative externalities such as medical costs of smoking or the cleanup of polluting industries, but it is unwise to use them as the base of the tax system.

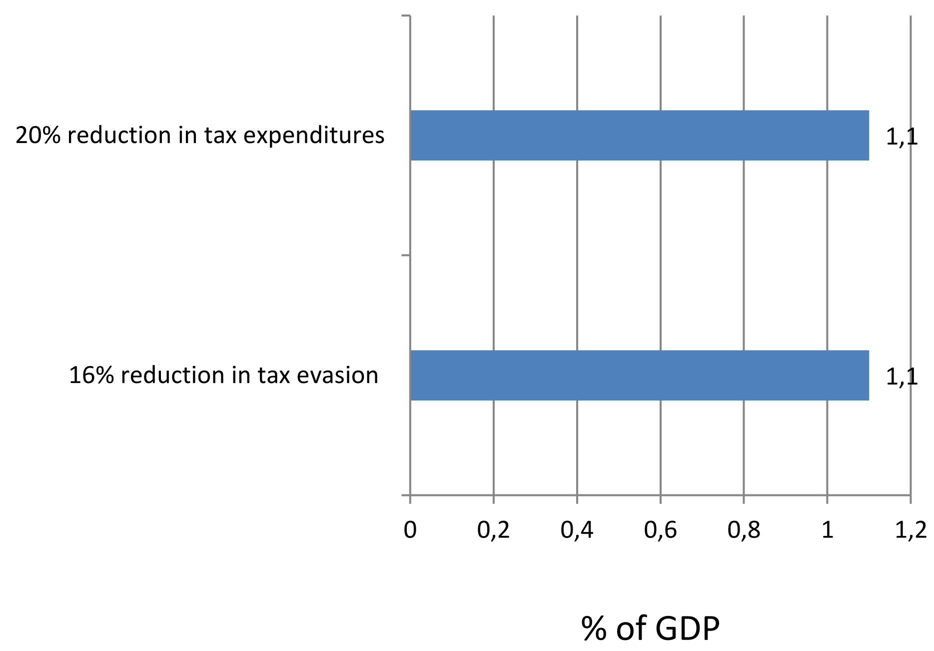
Taxation and "no new taxes"

In developing countries, there exists a significant gap between their actual tax in-take and estimated tax potential, known as tax gap.

Increases in the tax-to-GDP ratio occur only slowly over time; some low-income Sub-Saharan African countries have been able to raise tax revenues on an average of every three years during the past two decades.

While it is true that closing the gap may be feasible without new taxes, by definition closing the gap means more tax resources are being obtained from the taxpayers, and poorly designed tax systems may mean this is unfair.

Albania: Estimated additional resources from reducing tax expenditure and evasion



Why is it difficult to raise taxes?

Some of the failures to raise revenue in a taxation system may come from

- tax evasion (i.e. failure to pay or a deliberate underpayment) and avoidance (i.e. actions that lessen tax liability)
- tax exemptions
- inequitable rent-sharing in the natural resource sector
- lack of administrative capacity
- corruption
- grey area in legal framework
- international issues related to multinational corporations: here the newer international guidelines on price transfers and minimum corporate taxes may help.
- tax competition to attract foreign investment
- availability of aid
- adverse exchange rate impacts.

Taxation good practices

Progress in raising tax revenues can be made – given a strong political will to implement reforms. There are important commonalities in reform strategies for enhancing tax revenues recommended by the IMF:

- Build administrations that limit incentives and opportunities for rent-seeking and inappropriate behaviour
- Adopt clear laws embodying strong taxpayer protection and which combat tax evasion
- Eliminate exemptions that forego revenue to little public purpose
- Avoid tax competition or excessive fiscal concessions to multinational corporations;
- **Implement coherent regimes for taxing informal enterprises, linked to formalization policies to extend social security**
- Extend the personal income tax base, ensuring a coherent treatment of alternative forms of capital income;
- Introduce tax withholding for business and deduction of tax from pay-cheques by employers;
- Implement a broad-based VAT with a fairly high threshold and measures to off-set regressivity
- Levy excises on a few key items that are adequate to revenue needs and wider social concerns (e.g. CO_2 emissions, cigarettes, alcohol, sugary products, etc.);

Improve tax collection, tackle corruption

Here is where we see the logic of modern PFM becomes more salient

(i) **Efficiency:** New taxes or higher tax rates must not affect resource allocation or economic efficiency adversely to any significant extent.

(ii) **Fairness or distributional impact:** burden of tax should not fall on the poor or low-income households. In addition, the gender aspect of distributional impact needs to be considered.

(iii) **Compliance:** Costs that taxpayers incur in meeting their tax obligations. Any tax reform must try to minimize compliance cost.

(iv) **Administrative feasibility and cost**: Tax policy choices are influenced by a country's economic structure and its administrative capacity. Therefore, development partners should consider enhanced technical support for these countries in tax matters.

Significant amounts of revenue are lost through corruption. Widespread corruption harms the culture of compliance, thereby increasing tax evasion.

A recent IMF study finds that an improvement in corruption perception from the median to the 75th percentile is associated with higher revenues of 0.8 percentage point of GDP (IMF, 2016b). Tax administrative reforms in the Philippines since 2010 resulted in doubling annual tax collections. Two innovative pilot programmes since 2013 alone generated an additional US$300 million in tax revenue.

Taxation and the elasticity concern

The key problem in analyzing revenues from taxation is the negative elasticity of price-demand. Consider the VAT on a consumer product. If its rate is increased this typically implies that the price will increase, then consumers may prefer to reduce their consumption of the product. Therefore, the overall increase in tax revenue is less than the increase in the tax rate.

This concern applies to all types of taxes and indeed in optimal taxation discussions, elasticity is often a critical concern. For example, land is very inelastic so tax rates on land can be fairly high, whereas liquid financial wealth is extremely elastic due to its nature and so is difficult to tax, to the frustration of fairness-concerned policymakers.

Please note that this elasticity may or may not reflect tax evasion. Most of the time it will simply reflect changes in behavior of the consumers or producers.

Elasticity is hard to estimate well. Most advanced techniques use «kinks» or «notches» in the tax rates to figure out the true elasticity, but for practical purposes it is best to simply make clear assumptions and especially to avoid the belief that elasticity is zero or that it is extremely high.

Social Security contributions

- Collecting social security contributions is an important way to finance social protection.
- Social security contributions are linked to legal entitlements and should **not** be considered a tax but rather:
  - a deferred wage and
  - a social and economic investment.
- A well-designed social protection contributory system can:
  - enhance economic growth in the long run and
  - support inclusive development.
- Social security contributions are redistributive.

Social Security contributions

Social protection expenditure and its financing play a key role in sustaining social progress and ensuring social justice.

One of the most controversial issues in social security financing has to do with the alleged link between the level of social contributions and informality and unemployment. The argument is that social contributions raise the labour costs and therefore create informality and unemployment.

Alternative interpretation: However, informality and unemployment are the results of the interaction of a set of institutional, economic and social factors. Social security contributions are linked to legal entitlements and should be considered a deferred wage and a social and economic investment, rather than a simple item of labour cost as indicated by the term “tax”.

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Social Security contributions and the potential for “positive elasticity”

Consider this story of a basket of food.

You earn 100 dollars per week. One day, your employer tells you they have gotten a good deal on food and will deduct 10 dollars in exchange for a basket of food every week. If at the end of the week you receive a poor-quality basket of food that you value at 5 dollars, you will get angry and protest that you’d like a wage increase. However, if at the end of the week the basket you receive is more valuable than the money you were deducted, say, 30 dollars, your situation has improved and more people might be interested in working for the company. Net wages will decrease but employment will increase, because net wages plus the basket imply a gross wage of 120.

In other words, social security contributions, by its partial nature as deferred wages for the contributor, do not necessarily present the negative externality expected in taxes. However, **credibility of the promised benefits** is critical.

Social Security as insurance and stabilizer

Social security can be linked to economic growth because it enhances social stability and increases labor productivity, for example,

- Healthcare ensures workers are in good health
- Pension systems protect workers in old age and low productivity, allows them to smooth consumption level.
- Maternity insurance for working mothers
- Work injury helps rehabilitation of workers
- Unemployment benefits ensure workers will find better job matches.
- Child benefits may improve nutrition and health in children.

- In a crisis, the social security is an economic stabilizer.

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Social Security as fiscal space

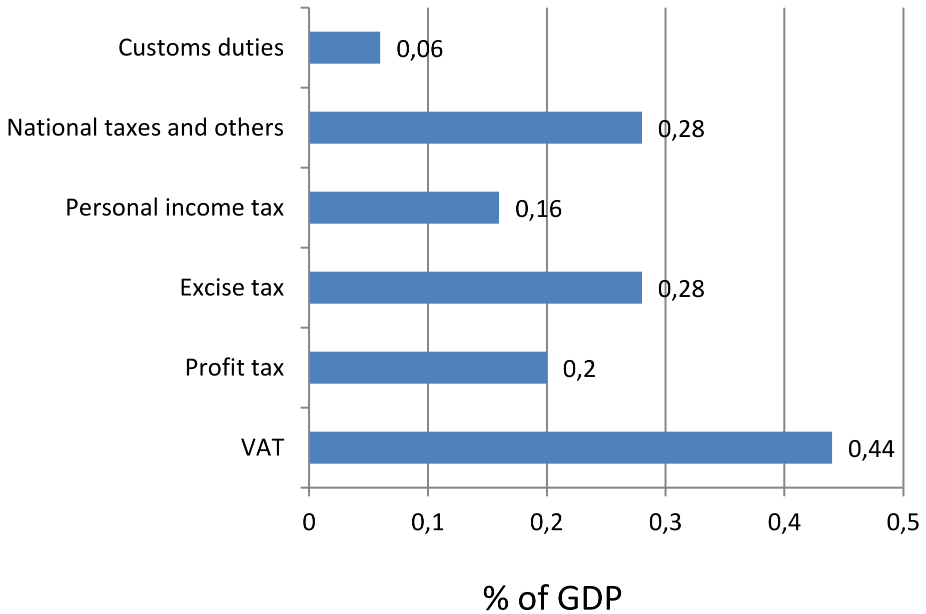
There are three main steps that, combined, can create fiscal space for social protection by using social contributions.

1. **Extending legal coverage** of social security schemes, through the extension of current schemes to new population groups and the creation of social security contributory programmes (e. g. new social insurance programmes in Africa and Asia). This includes extension to workers in informal economy.
2. **Extending effective coverage**, which increases the contributions' collection base. This is closely linked to the implementation of formalization policies in the areas of taxation, employment, and enterprise development.
3. Adjusting social security **contribution rates**. In countries where social security contributions are still low, social partners may sit down to negotiate gradual increases over the years in order to provide the system with the necessary resources as the social security system matures and the economy gains incremental capacity to expand contributory capacity

Albania example: role of institutional structures

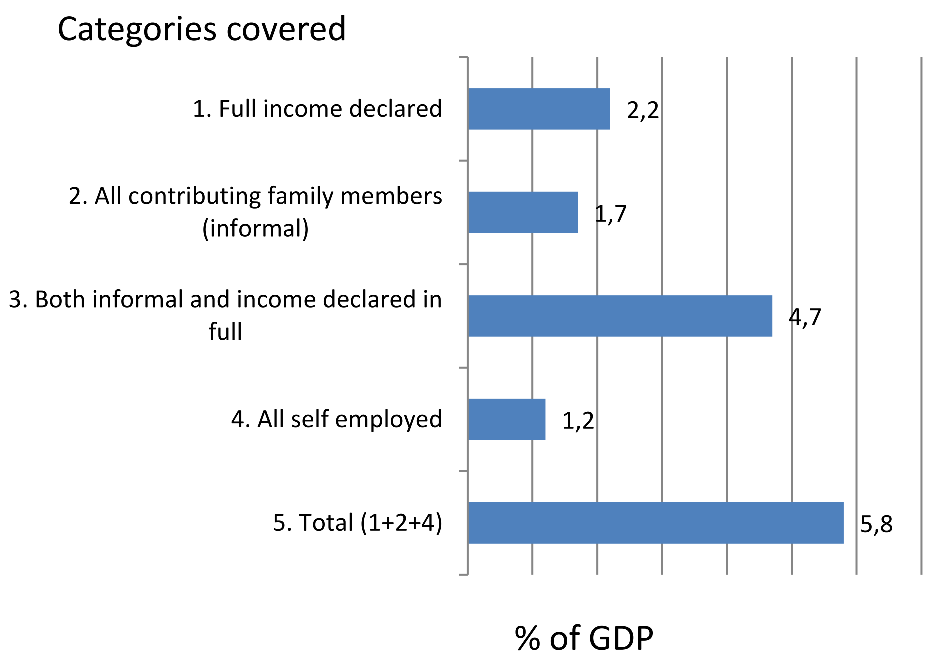
Taxation

Estimated additional resources from increasing tax rates by 1 percentage point



Social security contributions

Estimated additional resources from increasing social insurance coverage



The challenge of informality

It would be unwise to discuss social security without acknowledging that even if the scenario of positive elasticity may exist in some cases, in many cases poor economic performance may encourage many people to remain in the informal sector.

It is worrisome the persistence of informal sector in middle income countries that have higher GDP than comparable historical experiences in Europe. Some authors such as Dani Rodrik attribute this to the premature deindustrialization many countries have suffered.

1. What do you think are the causes of high informality in middle income countries? Is it different from low income countries?
2. Are high income countries at risk of increased informality as gig economy platforms become more common?
3. How can the world face this challenge together?

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Thank you

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