Fiscal Space Analysis and Eight Options for Financing Social Protection

Expenditure Reprioritization, Illicit Flows, ODA, Fiscal/Exchange Reserves

Improving Synergies between Social Protection and Public Finance Management

Woman working in Mexico © Sin Embargo.

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Quiz – Are you knowledgeable about ODA?

1. **How many OECD/DAC countries met the minimum target for ODA of 0.7% GNI (source: OECD 2020)?**

    A. None, B. Five, C. Ten, D. Fifteen

2. **How much is the average ODA expenditure of the OECD/DAC countries (% of GNI, source: OECD 2020)?**

    A. 0,17%, B. 0,32%, C. 0,73%, D. 1,14%

3. **How many countries and territories are on the DAC list of ODA recipients (source: OECD)?**

    A. Less than 50, B. Between 50 and 100,
    C. Between 100 and 150, D. Over 150

AFORE Movil, Mexico © Omar Flores

Structure proposed

- **Illicit Financial Flows**
- **Public Expenditure Reprioritization**
- **Fiscal and Exchange Reserves**
- **Foreign Aid**

Workers in Jordan. © ILO.

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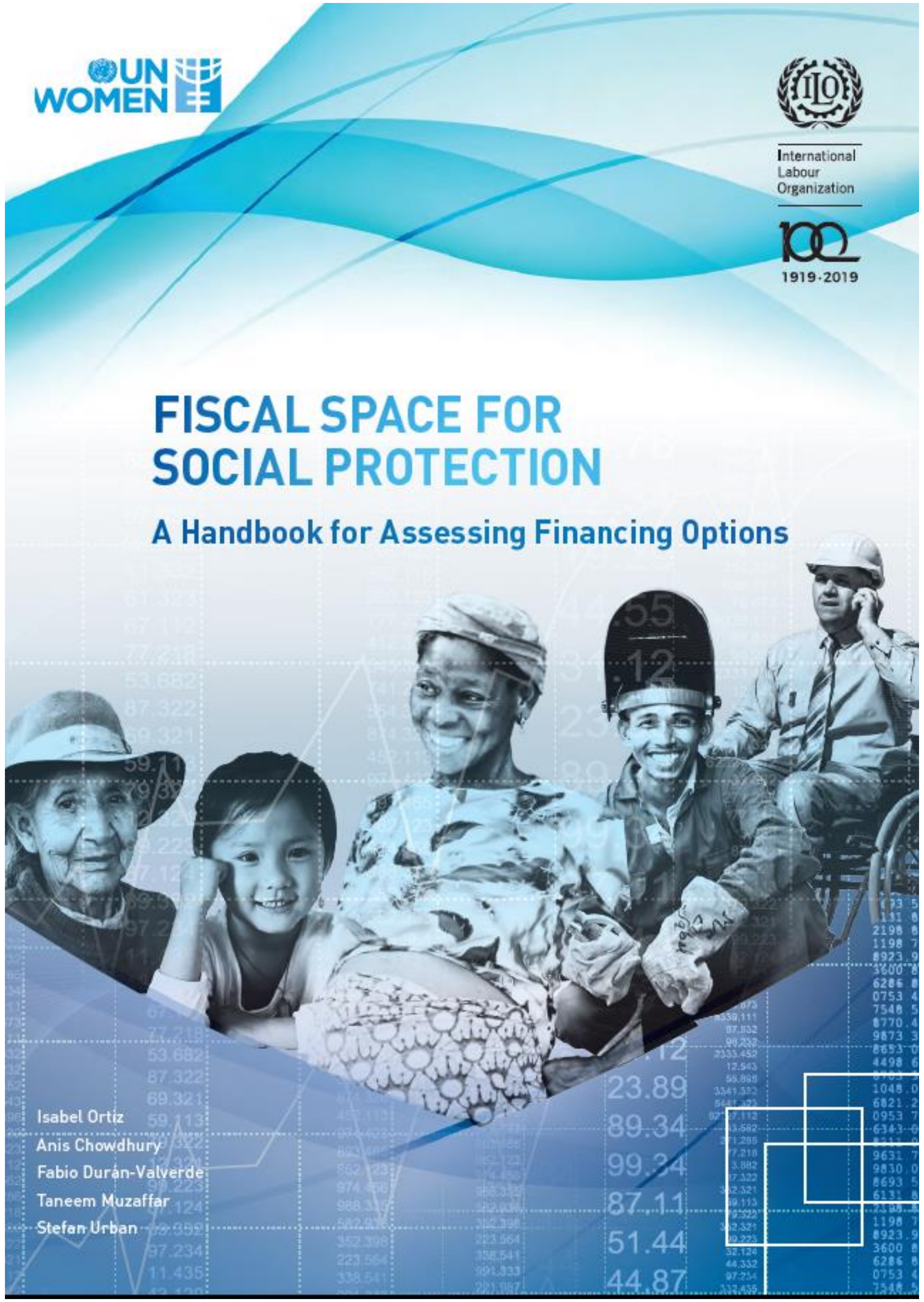
The concept of fiscal space

Fiscal space is defined as the resources available as a result of the active exploration and utilization of all possible revenue sources by a government, according to the ILO, UNICEF and UNWOMEN.

These UN agencies provide 8 financing options:

1. Expanding social security coverage and contributory revenues
2. Increasing tax revenues
3. Eliminating illicit financial flows
4. Improving efficiency and reallocating public expenditures from socially less desirable areas
5. Tapping into fiscal and foreign exchange reserves
6. Borrowing or restructuring debt
7. Adopting a more accommodative macroeconomic framework, and
8. Increasing aid and transfers.



Question #1 – Group work

How can fighting illicit financial flows and corruption contribute to finance social security?

Worker, Tuxtla Gutiérrez, Mexico. © ILO

Chapter 6

Illicit financial flows and corruption

What are illicit financial flows (IFFs)?

IFFs are generated by methods, practices and crimes aiming to transfer financial capital out of a country in contravention of national or international laws. They generally include:

- Funds with criminal origin, such as the proceeds of crime;
- Funds with a criminal destination, such as bribery, terrorist financing or conflict financing;
- Funds associated with tax evasion;
- Funds related to trade mis-invoicing and mis-pricing;
- Transfers to, by, or for, entities subject to financial sanctions;
- Transfers which seek to evade anti-money laundering /counter-terrorist financing measures or other legal requirements (such as transparency or capital controls).

Stemming IFFs and fighting corruption can be a significant source of fiscal space for socio-economic development.

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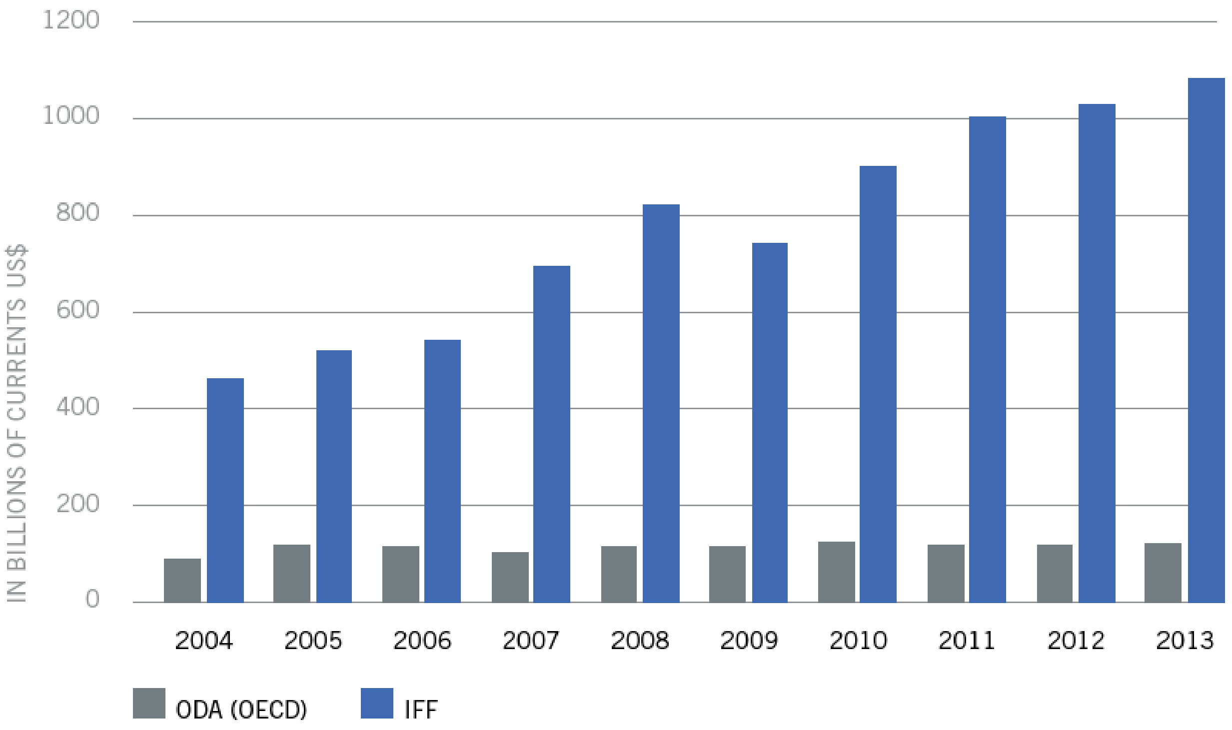
Why combat illicit financial flows and corruption?

Illicit outflows accounted for nearly 82 per cent of all net resource transfers from developing countries.

Developing countries lost US$13.4 trillion dollars through broad leakages in the balance of payments and trade mis-invoicing, while residents of developing countries held US$4.4 trillion in assets in tax havens —truly staggering amounts that, if adequately taxed, could be used for development with jobs and social protection.

Figure: IFFs vs. ODA, 2004-13* (in billions of current US$) – p.106



Note: *Only includes ODA given by OECD countries.
Source: Ortiz et al., 2017, based on World Development Indicators 2017; OECD, 2017; Global Financial Integrity 2015.

Measures to combat IIFS

It is clear that IFFs arise from multiple sources. Therefore, combating it would require coordinated cross-sectoral, cross-national approach. Policy coherence both domestically among government departments (ministries) and between national and international agencies is vital.

The figure shows key actors who need to be involved to design and implement different (albeit mutually reinforcing) policies and actions at different levels of government to combat IFFs.

Figure: Key actors involved in combating IFFs – p.106

Source: UNODC-OECD, 2016.

Some challenges

The measures to combat IFFs involve a wide range of policy areas, domestic and international. This can potentially create policy conflicts between objectives relating to IFFs and other policy objectives as well as unforeseen conflicts which may arise from the way policies are implemented – these are minor, considering the large public benefits of combatting IIFs.

Some of the challenges are:

- Financial inclusion
- De-risking and migrant remittances
- Data Protection
- Voluntary Tax Compliance Programmes
- Impact on markets and financial stability
- Spill-over
- Diplomatic Relations

Key messages - Illicit financial flows and corruption

- Curtailing IFFs can generate substantial amount of resources for critical economic and social investments, given the vast amount of resources that illegally escape developing countries each year. However, no individual country can succeed on its own, given its complexity and web of cross-boundary activities.

- In particular, developed countries have a responsibility to support developing countries' efforts by not only providing technical assistance, but also implementing measures themselves against bank-secrecy, tax-havens, international bribery and MNCs' profit shifting. Therefore, finance ministries and tax authorities in developing and developed countries need to cooperate in a global resource bargain to close existing loopholes that help IFFs.

- International civil society organizations (CSOs), such as Global Financial Integrity and Tax Justice Network, are playing critical role in creating awareness and constructing data by researching on IFFs, offshore finance and tax havens. National CSOs should join hands with such organizations to monitor progress at the national level, especially in implementing various UN Conventions to combat sources of IFFs.

Question #2 – Group work

Have you seen an example of expenditure reprioritization in favour of social security in your countries? How did it happen?

Worker, Tuxtla Gutiérrez, Mexico. © ILO

Chapter 7

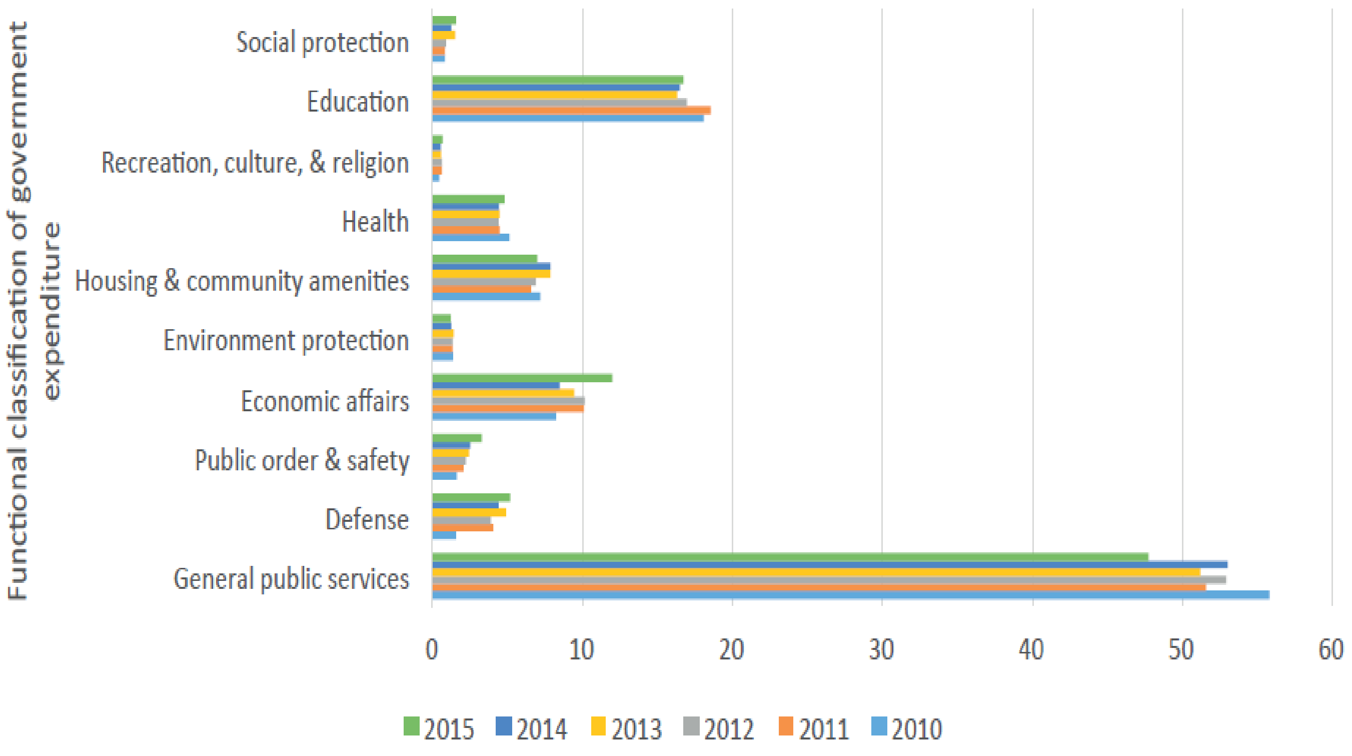
Public expenditure reprioritization

Why expenditure reprioritization?

Expenditure reprioritization is an option to increase the share of government spending on social protection by discontinuing or replacing high-cost or low-impact investments with others with larger social impacts,

It is necessary to be alert to prevent expenditure reprioritization that are regressive – such as budget cuts with significant negative social impacts. If the reform cannot be redressed with an alternative policy, it must include compensatory programmes to mitigate the negative impacts on the population.

An illustration using Indonesian data.
Figure: Public expenditure in Indonesia by function (per cent of total government expenditure), 2010-2014 – p.117



Source: IMF, Government Finance Statistics (GFS).

Public expenditure reviews (PER):

PERs are becoming increasingly important in view of growing pressure on public expenditure, especially when the scope for raising revenues commensurately through traditional means (e.g. taxation) is limited.

Though expenditure reprioritization is the most commonly advised financing measures, it is actually one of the most difficult options, as it tends to be resisted by those who lose out due to cuts or elimination of programmes. Social dialogue and public open debates are strategic tools to minimize the influence of powerful lobbying groups on public policy-making.

PERs reinforce the connection between funding decisions and policy priorities and between funding levels and results delivered to end-users. The overarching goals of evaluation are generally the following:

i) to assess a public policy and its impact versus fact-based public needs,

ii) to provide evidence to help policy-makers establish whether an intervention is successful or not,

iii) to define the scope for improvement, strategic overhaul or operational resources adjustment.

Key messages - Public expenditure reprioritization

- Expenditure reprioritization does not create new fiscal space in the overall budget, but it is an option to increase the share of government spending on social protection.

- There is no one-size-fits-all methodology for spending reviews or expenditure reprioritization, and some can be very complex as well as costly and time consuming. Yet, expenditure reviews can be done by following some simple steps.

- An expenditure reprioritization exercise should be part of regular budgetary process for ensuring desired public policy outcomes of expenditure allocations.

- Regressive reprioritization, such as austerity cuts, should be avoided as it leads to detrimental social impacts. Interest groups play an important role in determining public policy priorities and budgetary allocations.

- However, it should be borne in mind that expenditure reviews and reprioritizations do not generally yield substantial savings to be used for expanding social protection coverage. Reprioritization is usually sensitive and therefore politically difficult.

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Question #3 – Group work

How can fiscal or foreign exchange reserves be used to finance social protection? Aspects to take care?

Worker, Tuxtla Gutiérrez, Mexico. © ILO

Chapter 8

Using fiscal and foreign exchange reserves

Fiscal and foreign exchange reserves

Since the late 1990s, many developing countries have accumulated significant amount of fiscal and foreign exchange reserves, often as a policy of “self-insurance” to prevent the need to borrow in case of crises/shocks.

Fiscal reserves and central bank foreign exchange reserves are potential sources of financing for investments in socio-economic development accruing to women, children and other social groups.

Fiscal reserves are collected through government budget surpluses, profits of state-owned companies, privatization receipts or other government net income.

Foreign exchange reserves consist of official public sector foreign “assets that are readily available to and controlled by monetary authorities for direct financing of external payment imbalances and to intervene in the exchange markets” (IMF, 1993). These could be foreign (private or public) securities, foreign currencies and other assets in foreign currencies, such as derivatives or equity futures.

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Using foreign reserves for development: public investments, national and regional development banks

Many, including within central banks, the UN and the IMF, have expressed concerns at the recent rise in size and the strategy itself of reserve accumulation as self-insurance. They point to the significant opportunity costs related to the maintenance of funds in currency and asset portfolios that produce returns lower than those of many alternative investments, such as social protection.

It is therefore important to consider how foreign currency reserves can be used for social and economic investments. The simplest way to do so is to do public investments; for example, allocating excess reserves to one or several Ministries so they extend their current programmes.

In addition to financing domestic projects, developing countries can also seek to achieve longer-term investment returns on their excess foreign exchange through national and regional development banks.

Key messages - Using fiscal and foreign exchange reserves

- Fiscal and foreign exchange reserves present possibilities for governments to enhance fiscal space for social protection.

- There is now consensus that countries should use macro-prudential regulations to manage capital flows; there are also regional swap and financial safety-net initiatives.

- These developments mitigate the precautionary needs for holding excess foreign reserves and hence widen the scope for their domestic use within an accommodating macroeconomic policy framework. This scope is further enhanced by a globally low inflationary environment.

- Considering the huge financing gap, therefore, countries should look for investing at least some of their excess foreign reserves for closing their development deficits.

- Sovereign wealth funds, national and regional development banks, and simply public expenditures offer a good vehicle for fiscal and foreign reserves to earn better returns and expand their social protection coverage.

Question #4 – Group work

How can foreign resources be used to finance social security? What perspective for a global solidarity fund?

Director ISSTECH, Chiapas, Mexico. © ILO

Chapter 11

Foreign aid

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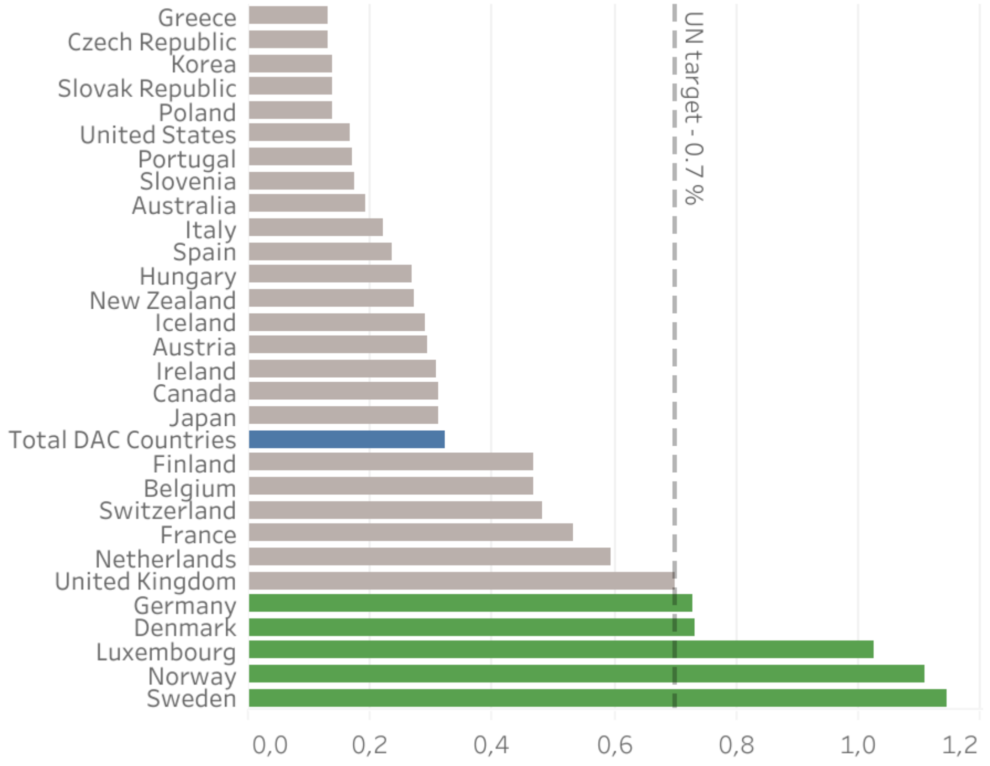
Compare your Country

Official Development Assistance 2020 – Preliminary Data

Sort countries by
- both measures
- ODA grant equivalent
- ODA as % of GNI

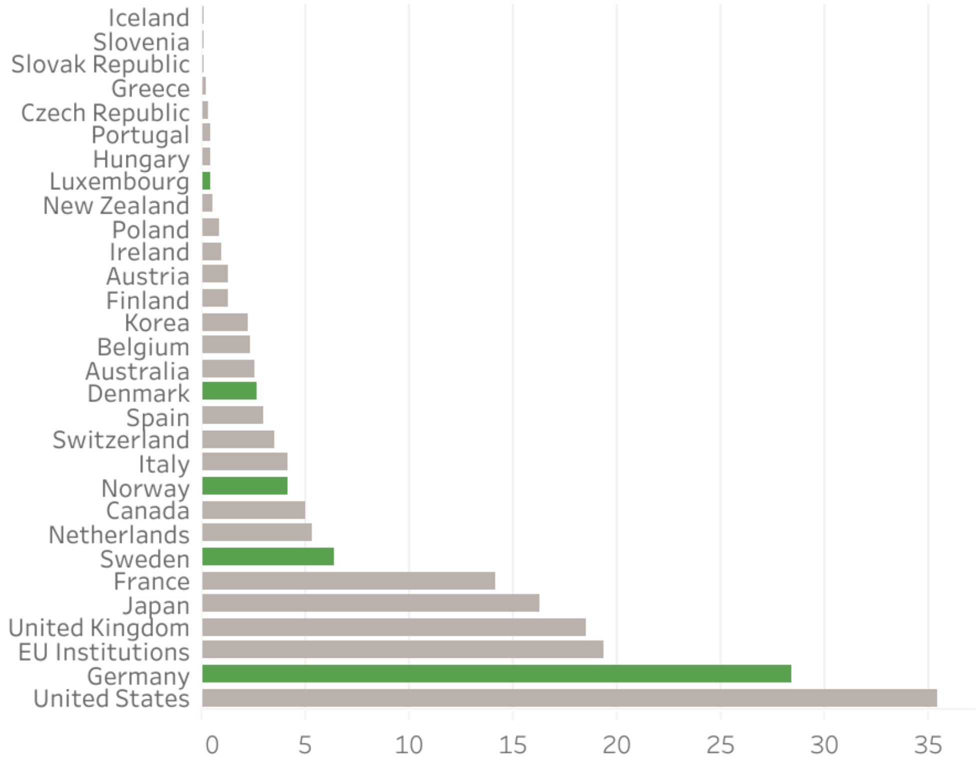
ODA grant equivalent as percent of GNI (2020)



ODA on a grant equivalent measure by members of the OECD Development Assistance Committee (DAC) as percent of gross national income (GNI). Preliminary data for 2020.

Source: OECD (2021), DAC Statistics

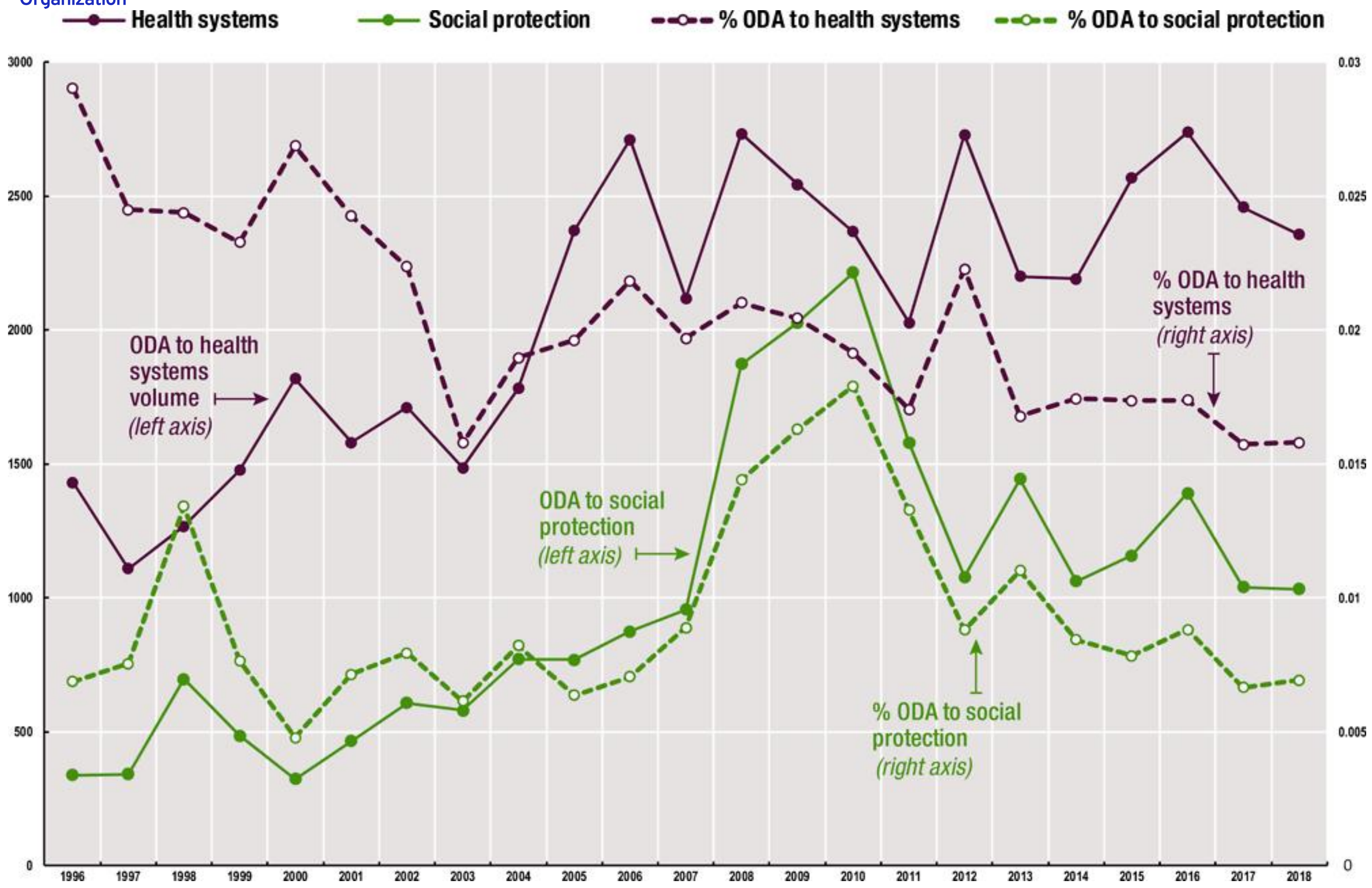
ODA grant equivalent - USD billion (2020)



ODA on a grant equivalent measure by members of the OECD Development Assistance Committee (DAC). Preliminary data for 2020.

Data source: DAC 1 - Total official and private flows

ODA for health and social protection – 1996-2018



Note: ODA commitments include those of DAC countries, plus the European Union institutions. Purpose codes used for health systems include 12220, 12230, 12261, 12281, 13030 and 13081; for social protection, 16010.

Source: OECD Statistics, 2020.

https://www.oecd-ilibrary.org/sites/5e331623-en/index.html?itemId=/content/component/5e331623-en

Why scale up foreign aid?

Foreign financial aid in the form of Official Development Assistance (ODA) can play an important role, especially in least developed countries (LDCs) or low-income countries (LICs).

Historically foreign aid played a significant role to accelerate economic and social development. The US Marshall Plan to aid Western Europe’s reconstruction following WW II is the testimony of what injections of large amount of foreign aid can achieve.

ODA, traditionally a tool for North-South support, is increasingly complemented by South-South transfers, thus increasing the variety of financial sources and development cooperation partnerships for developing countries.

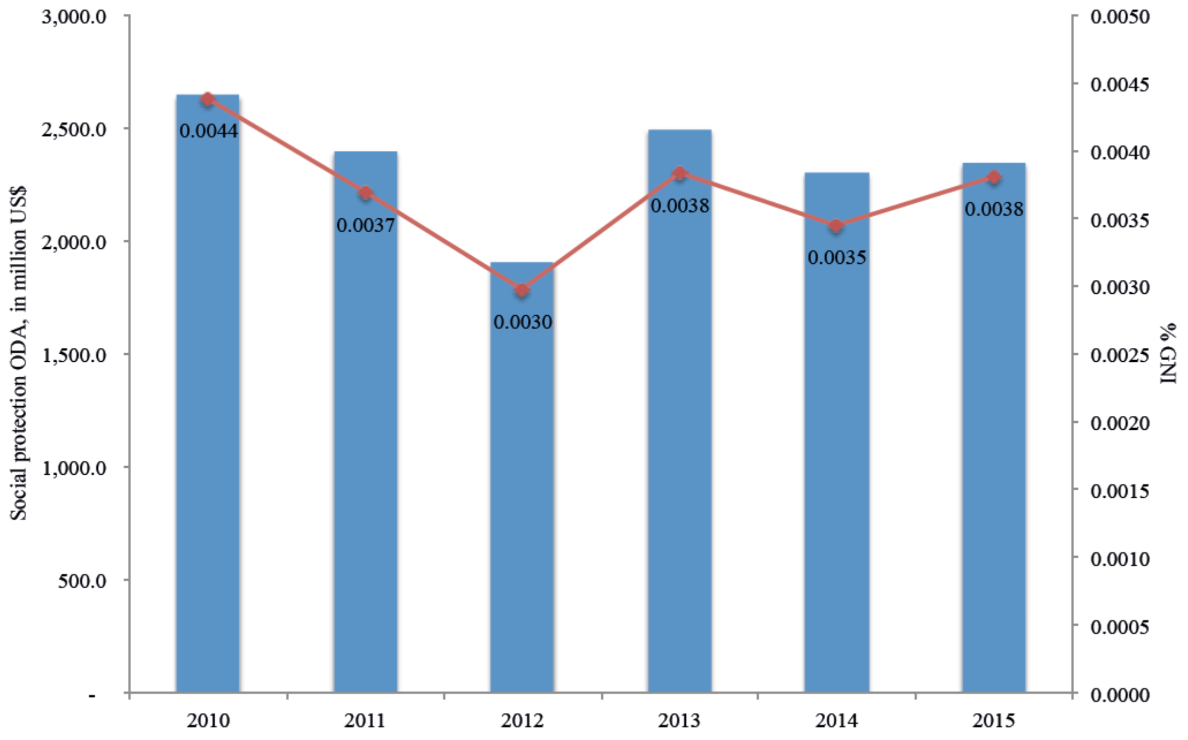
North-South transfers: Official Development Assistance (ODA)

In principle, ODA should be a first option for expanding fiscal space for developing countries, LDCs/ LICs in particular. However, there is significant uncertainty surrounding future aid flows in a climate of fiscal consolidation that is increasingly taken hold of many traditional donor countries since 2010.

Some of its issues are:

- Conditionality
- High transaction costs of ODA
- Tied aid
- Size, predictability and longevity of ODA
- Concentration of ODA.

Figure: ODA for social protection: total disbursements as per cent of GNI, 2010-2016 – p.178



Source: OECD DAC database

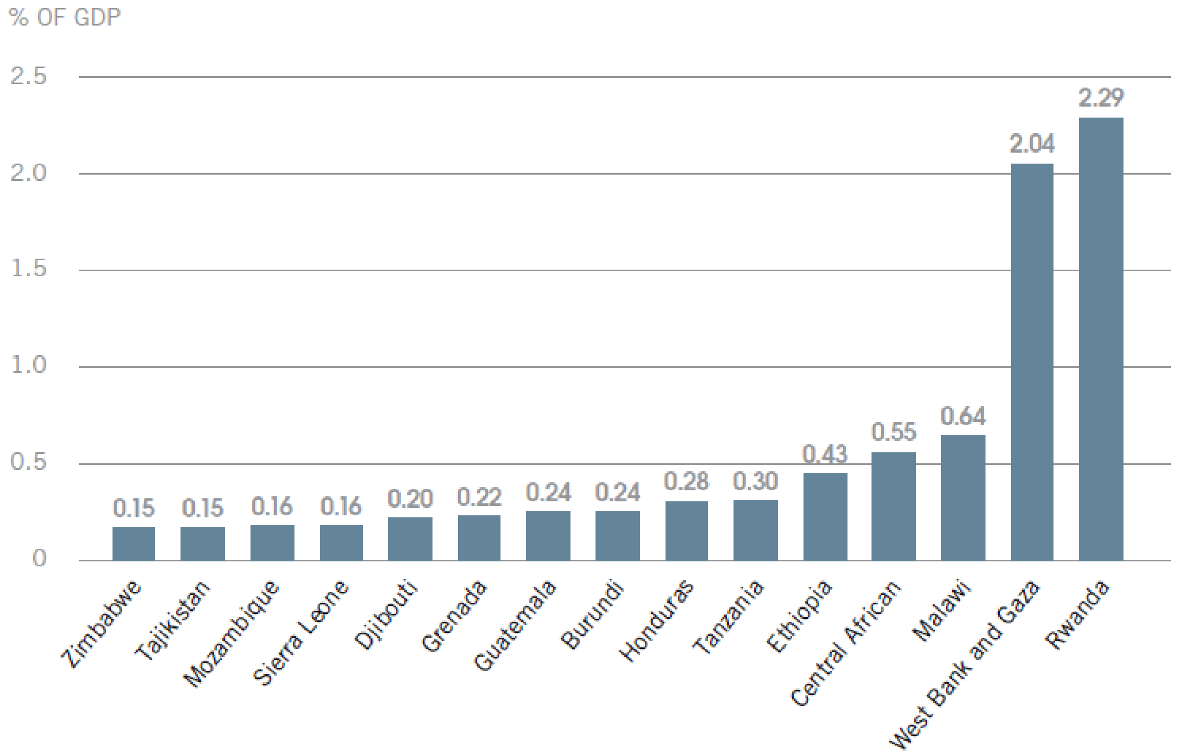
North-South transfers: Official Development Assistance (ODA)

Current aid levels remain far below the 0.7 per cent of GNI threshold that was set as a UN target in 1970 – repeatedly re-endorsed at the highest levels.

Aid is also concentrated in a few recipient countries, neglecting the financing needs of many other developing countries.

ODA funding for social protection is highly concentrated in a few regions of the world. Sub Saharan Africa, South Asia and Central Asia and the Middle East receive seven out of ten US dollars (71.6 per cent) devoted to that sector.

Figure: ODA for social protection as a per cent of GDP, 15 highest beneficiary countries – p.183



Source: OECD DAC database

South-South cooperation

South-South cooperation dates back to the Asia-Africa Conference of 1955 held in Bandung, Indonesia, where countries which gained independence pledged to support the aspirations of others.

South-South transfers are becoming increasingly important, especially since the mid-2000s. They take place through three main channels of cooperation:

- bilateral aid,
- regional integration, and
- regional development banks.

For governments, South-South transfers are a clear avenue to tap into regional and cross-regional resources for social and economic development.

Triangular cooperation

There is no strict definition of triangular development cooperation, but in general it involves a Northern donor (e.g. international organization, DAC donor) who finances projects and programmes executed by Southern countries. It is also often referred to as a South-South cooperation with additional support from a northern partner, while the support can come in the form of financing or by providing expertise, or both (ECOSOC, 2008).

In a survey conducted by the OECD on triangular cooperation, the United Nations agencies are listed as the most frequented partners in triangular cooperation, followed by Japan and Germany. Brazil, Chile, China, Mexico and South Africa were most mentioned by development cooperation agencies, international organizations and other developing countries as their southern triangular cooperation partners.

In the OECD survey, Non-governmental actors were also mentioned as triangular cooperation partners, while Africa was highlighted as the region benefitting most from triangular cooperation, followed by the Americas and Asia.

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Key messages - Foreign aid

- The levels of ODA are far from the UN commitment of 0.7 of GNI of donor countries. In reality, the share of disbursed ODA allocated to social protection represented a mere 0.0047 per cent of the gross national income of donor countries in 2017 (ILO, 2020). But ODA can and indeed does contribute to build social protection systems/schemes in developing countries.

- There are opportunities to scale-up North-South and South-South financial transfers, including transfers in the framework of a triangular set-up, and an array of innovative sources of development financing available to donor countries.

- For low-income countries and LDCs, it is essential to actively seek partnerships to attract foreign donor support, as not every country is equally present in the minds of donors. Some of the poorest countries in the world receive limited aid flows.

- While there are various forms of donor support, the trend is towards budget support accompanied of technical assistance; this trend also reflects the guidelines set out by the DAC Development Committee and UN resolutions.

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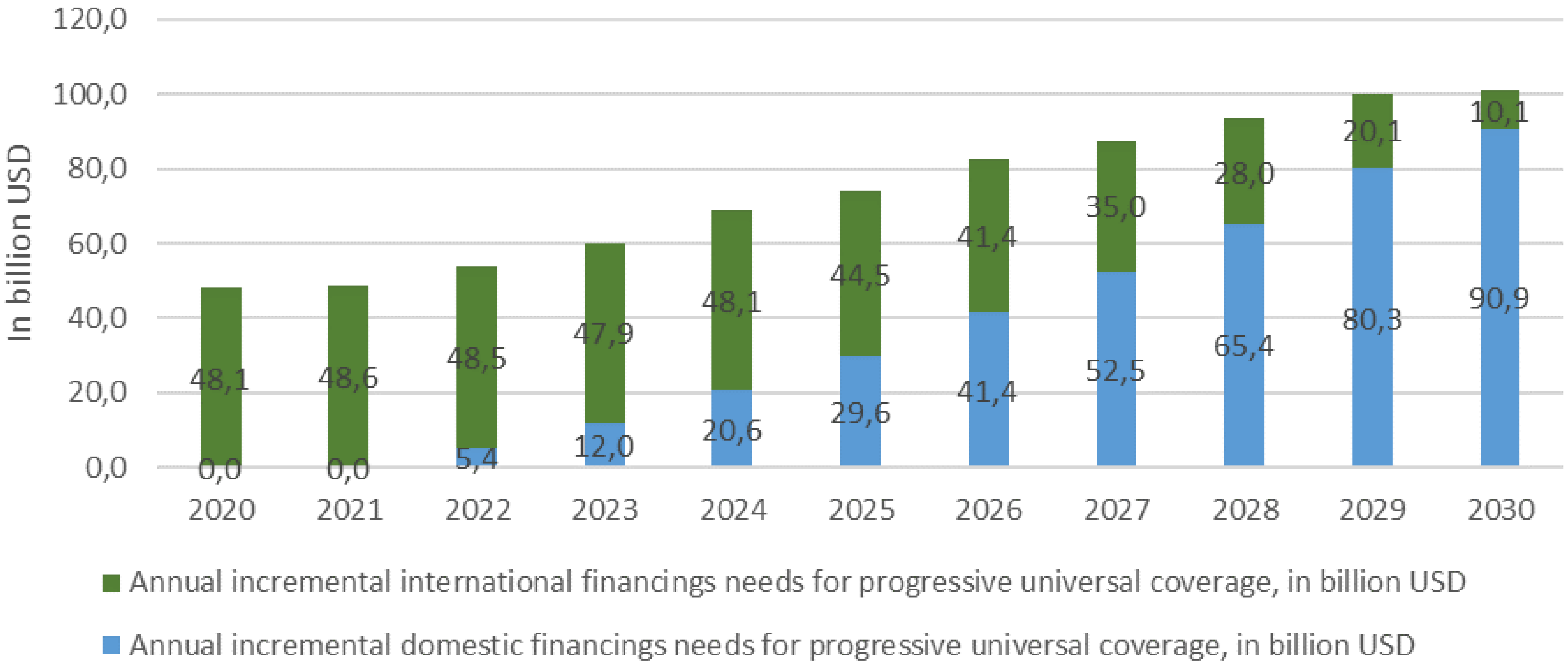
Progressive increase of financing social protection – projection needed to extend SPF in low income countries to all by 2030

Progressively increase domestic resources to build sustainable social protection systems.



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Country experience: Albania

Financing Social Sectors for Vulnerable Groups

27 September 2021

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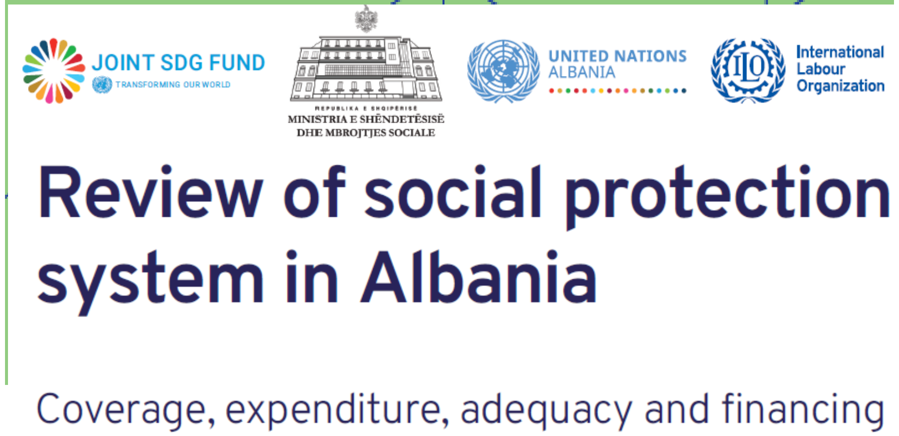
Assessment of fiscal space for social protection in Albania



Available at:
https://www.ilo.org/budapest/what-we-do/publications/lang--en/index.htm

Structure of the Study on Fiscal Space (Ex. Albania)

Contents

Albania, Streetvendor. © Twitter Janet King.

Albania: Two UN Joint Programmes funded by the Joint SDG Fund

- Catalyzing municipal social protection
- Strategic policy options for SDG financing

Map Albania © Factmonster

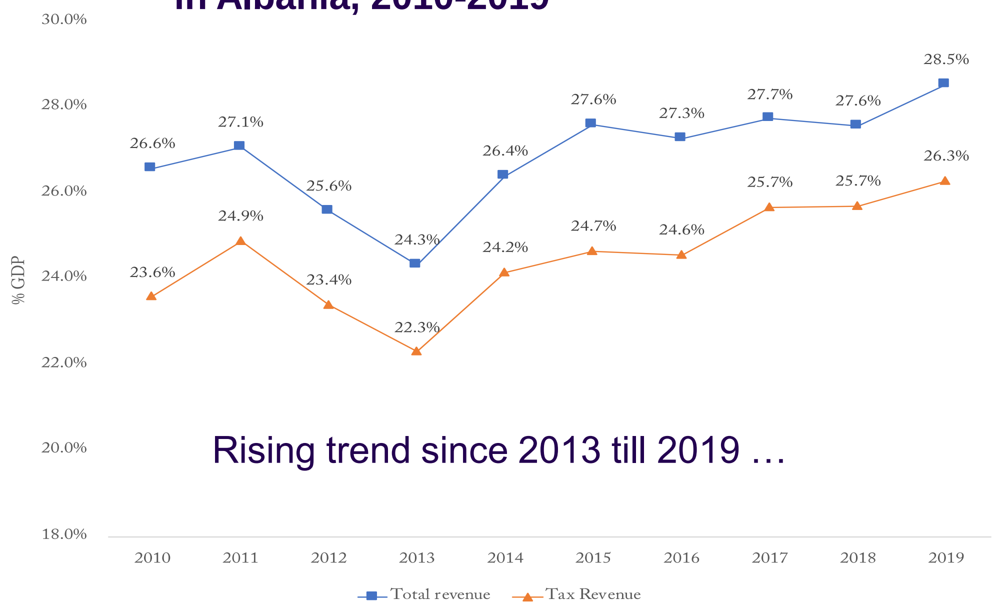
ILO contributions

- Review of the social protection system in Albania
- Assessment of fiscal space for social protection
  - Analyzes gaps in the financing of social protection
  - Develops options to create fiscal space for building a comprehensive system including national social protection floors
- Assessment, design and costing of social protection programmes
  - Childcare and child allowance
  - Long-term care benefits and services
  - Assessment of the targeting of economic assistance
- Feasibility study of innovative financing mechanisms.
- Financing options for a shock responsive social protection including the response of COVID-19
- Policy dialogue amongst national stakeholders

Fiscal space options for Albania (1)

1. The twin shocks to the economy have significant implications for public finance – deteriorating revenue collection and rising fiscal deficits.
2. The report analyses fiscal space options based on historical data before the pandemic.
3. Ministries of Finance/Planning should explore all possible fiscal scenarios and options, associated social impacts including gender issues, risks and trade-offs.
4. The set of alternative policy options for inclusive development should be discussed amongst all stakeholders in a **national social dialogue**.

Trends in total revenue and tax revenue in Albania, 2010-2019

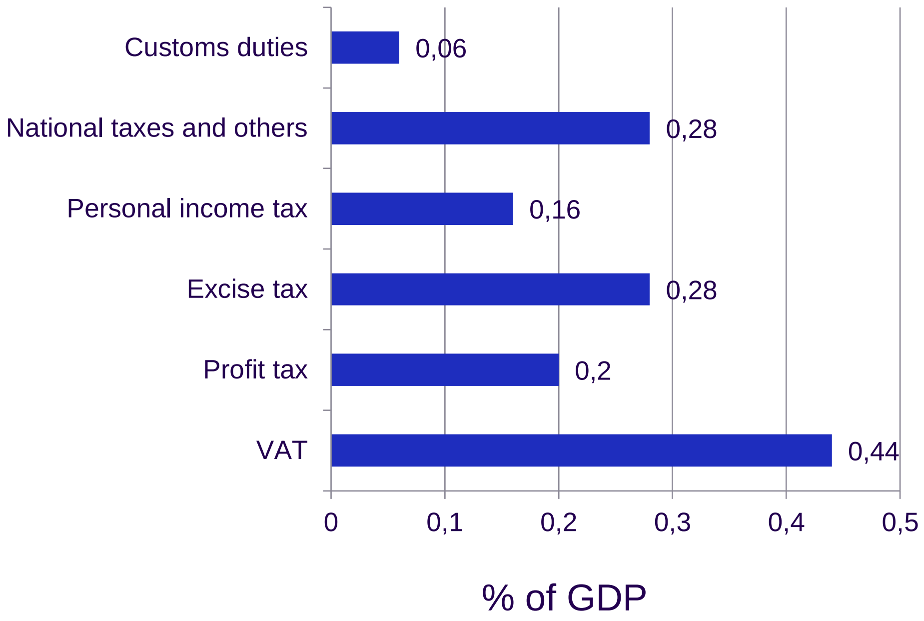


… but fiscal revenue in 2020 under pressure due to economic contraction and measures to reduce or defer taxes. Tax revenue during Jan-Sept 2020 down by 10.6 per cent (y-o-y) (Source: IMF).

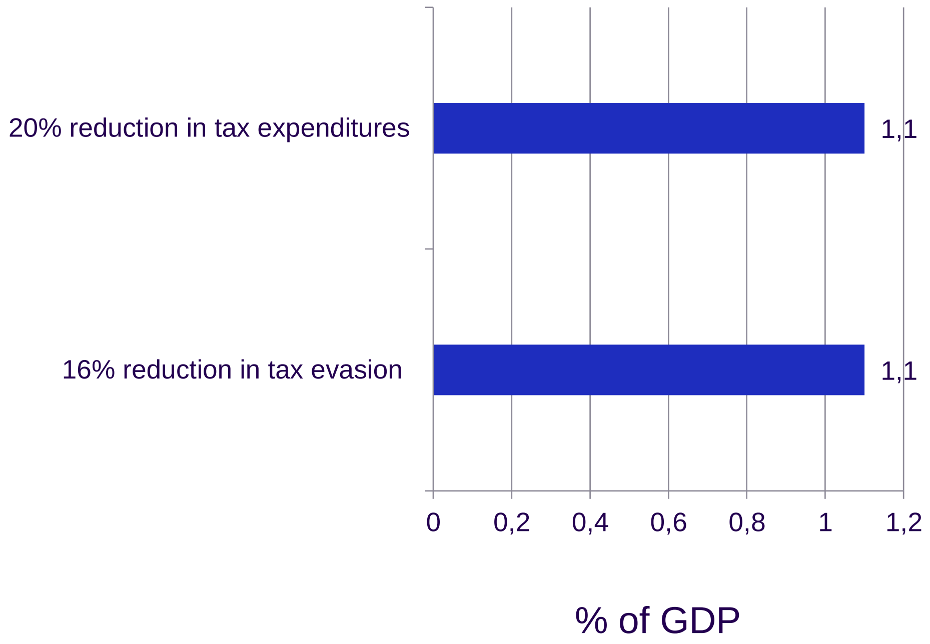
Fiscal space options for Albania (2)

Taxation

1. Estimated additional resources from increasing tax rates by 1 percentage point



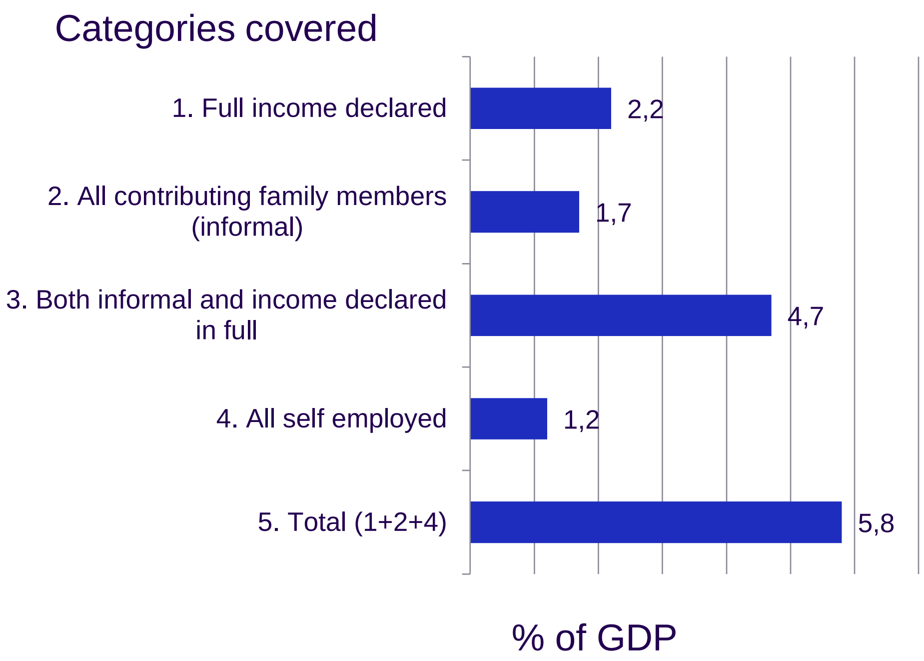
2. Estimated additional resources from reducing tax expenditure and evasion



Fiscal space options for Albania (3)

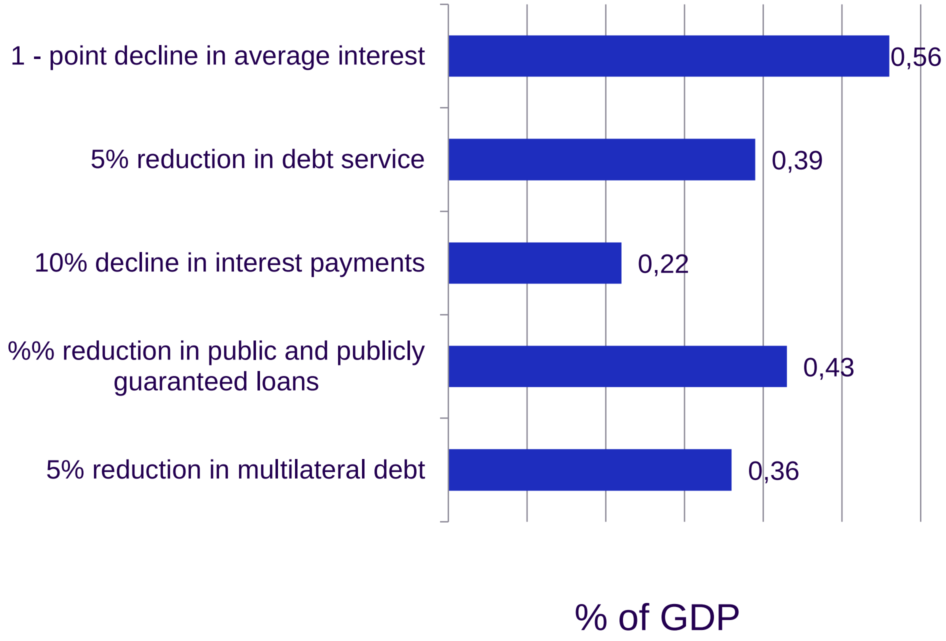
Social security contributions

Estimated additional resources from increasing social insurance coverage

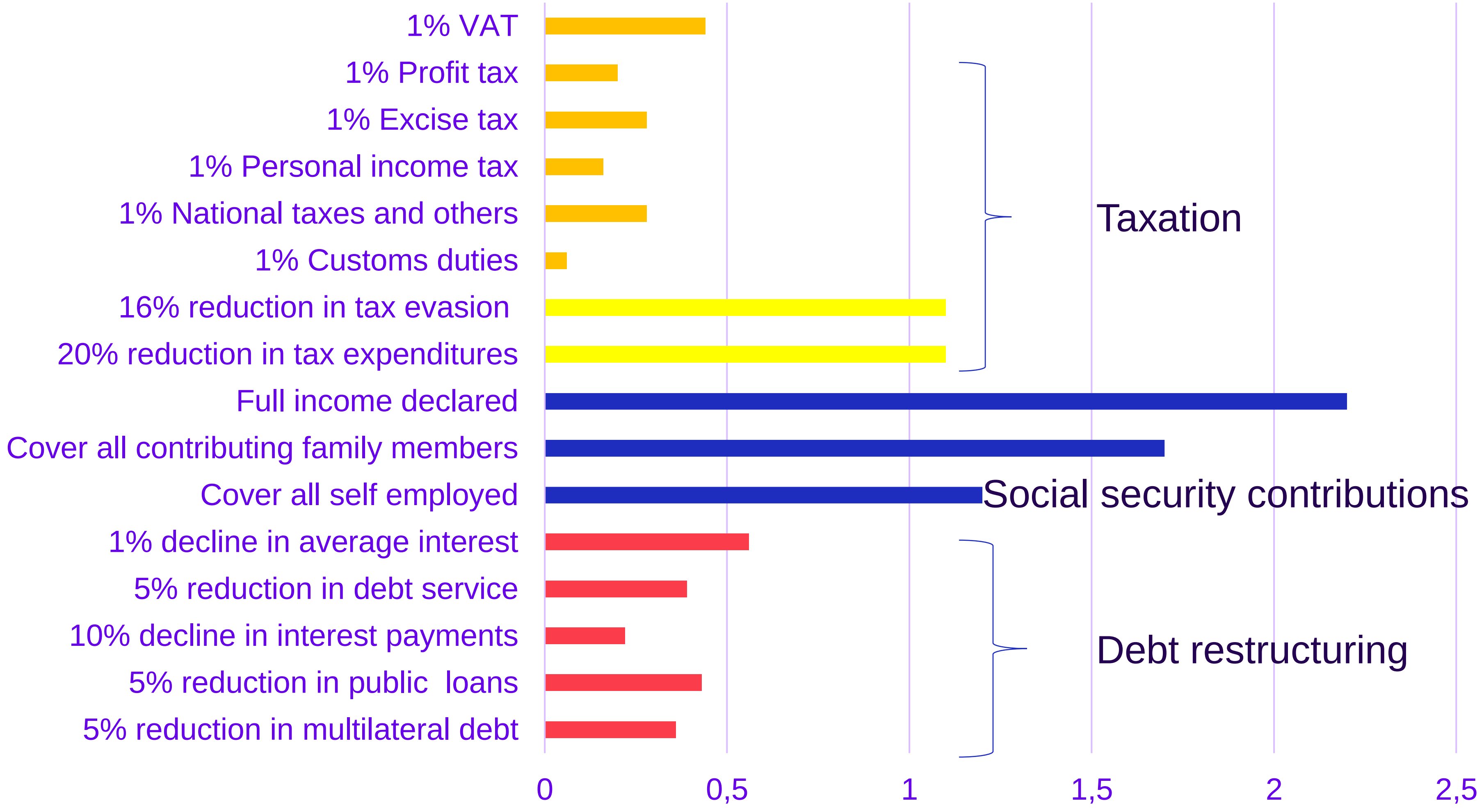


Debt restructuring

Estimated additional resources from debt related policy targets



Fiscal space options for Albania (% GDP)



Fiscal space options for Albania (4)

Other options to create fiscal space

1. A 20% reduction in illicit financial flows could generate between **0.23 – 0.58** per cent of GDP.
2. 20% of the reserves in excess under the most restrictive scenario could generate **0.40** per cent of GDP.
3. A more accommodative macroeconomic policy by setting fiscal deficits at 2 per cent of GDP could generate about **0.40** per cent of GDP.
4. Expenditure reprioritization has a very limited scope of creating additional resources for financing social protection.

Comparative final table

▶ Table 7. Financing options and resource generation

Macro-category	Scenario	% of GDP
Expanding social security coverage and contributory revenues	Universal coverage of workers	5.8
Increasing tax revenue	VAT, additional 1 %-point	0.44
	Profit Tax	0.20
	Excise Tax	0.28
	Personal Income Tax	0.16
	National Taxes and others	0.28
	Customs Duties	0.06
	16% reduction in tax evasion	1.10
	20% reduction in tax expenditures	1.10
Eliminating illicit financial flows	20% reduction of illicit flows	0.23–0.58
Public expenditure reprioritization	10% re-prioritization of general public services and order safety recent gains in the budget structure	0.05
Use of fiscal and foreign exchange reserves	20% of the reserves in excess under the most restricted scenario	0.4
Debt restructuring	1-point decline in the average cost of the Albanian debt	0.56
	5% reduction in the debt service	0.39
	10% decline in the interest payments	0.22
	5% reduction in the public and publicly guaranteed (PPG) loans with IDA and IBRD	0.43
	5% reduction in the multilateral debt	0.36
Adopting a more accommodative macroeconomic policy	Set fiscal deficit at 2% of GDP	0.40

Source: ILO staff estimates using data from the IMF, World Bank, and national authorities.

Albanian woman. © Albania-the-Mirror.

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Observations and lessons learned so far

- First attempt to quantify possible fiscal options to create fiscal space for social protection.
- More useful for the central government than local municipalities
- Reiterated the challenges of the existing system, e.g. low spending, high informality.
- Useful instruments to motivate and navigate the policy discussion with quantitative information.
- Need to build a consensus based on a national dialogue by all stakeholders.