

How to Finance Inclusive Social Protection



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How to finance inclusive social protection

This is the fourth in a series of policy guides developed to support policymakers and practitioners in Asia and the Pacific in their efforts to strengthen social protection. This guide examines ways to finance social protection, with a focus on tax-financed social security schemes.

This policy guide will outline the options for countries to increase investment in social protection through general government revenues. The guide will also briefly discuss social insurance schemes financed through contributions. Ideally, countries should build systems that are funded from both sources to ensure minimum income security for all citizens and residents and to smooth consumption levels over the lifecycle.

SOCIAL PROTECTION AS A SOCIAL CONTRACT

Financing social protection is the responsibility of the State.

A broad political consensus that positions social protection as a vital investment in human capital is essential to ensure long-term financing and national ownership.

Social protection that reaches all women, men and children demonstrates a government's commitment to invest in its people. This forms a contract of mutual obligations, where citizens and residents pay taxes to the State and receive benefits and services in return, which strengthens trust and solidarity between society and the State. People are more willing to pay taxes when they are included in, and benefit from, tax-financed social protection schemes. Allocating sufficient taxes and other revenues to inclusive schemes that build a social protection floor¹ for all women, men and children throughout the life cycle is therefore vital to achieving social cohesion and strengthening the social contract.

Tax-financed social protection is particularly important in Asia and the Pacific where those employed in the informal sector make up 60 per cent of the working-age population.² Those in informal employment are rarely covered by contributory social protection schemes and often earn low and irregular wages that are paid in cash, making taxation a challenge. The bulk of national tax revenue from labour is therefore received from those in formal employment. Within this context, universal social protection schemes that cover the entire population, whether in the formal or informal sector, promote solidarity and inclusion.

CURRENT INVESTMENTS IN SOCIAL PROTECTION IN ASIA AND THE PACIFIC ARE LOW BUT INCREASING

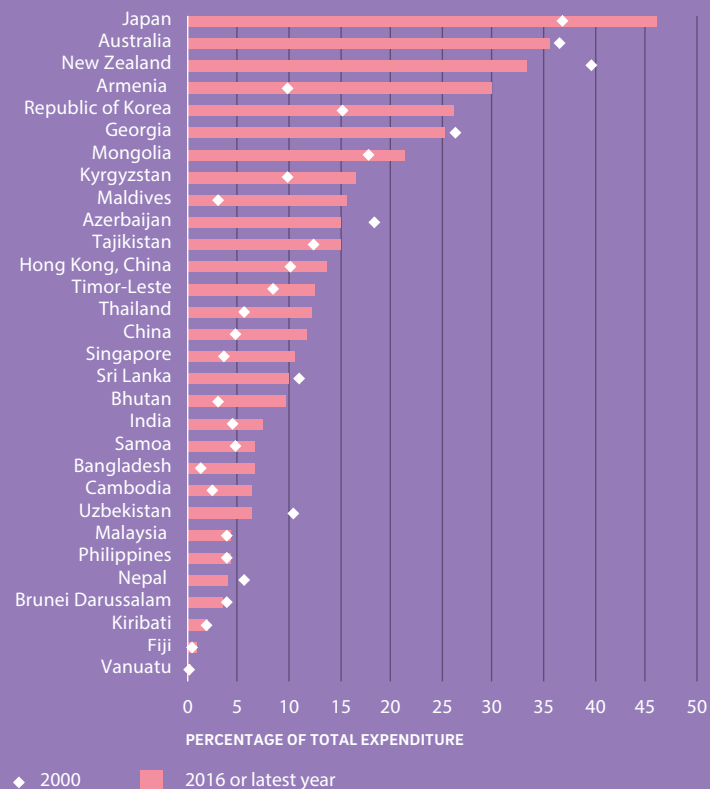
Most countries in Asia and the Pacific recognize the importance of investing in social protection and have also increased investments over the past two decades. As illustrated in Figure 1, 18 out of 30 countries and territories in Asia and the Pacific, for which data are available, increased social protection spending as a share of total government expenditures between 2000 and 2016. Nonetheless, countries in the region spend on average only around 14 per cent of total government expenditures on social protection. This is significantly lower than the average level in, for example Europe, where investments average 42 per cent of government expenditure.³ Countries aspiring to reduce poverty and vulnerability should therefore consider increasing levels of investment in contributory and non-contributory social protection.

To reach the most vulnerable groups it is especially important to invest in tax-financed social protection. While government investment in social protection has generally increased, investment in tax-financed non-contributory social protection remains low with a regional average of 1.3 per cent of GDP.⁴

The highest levels of investment are found in developing countries aiming to build national social protection systems that are inclusive. For example, in Georgia, the highest investor in the region, an expenditure of 7 per cent of GDP supports a variety of social assistance programmes, including universal old-age pensions, which has successfully reduced the extreme poverty headcount at \$1.90 a day by 90 per cent.⁵



FIGURE 1 MOST ASIA-PACIFIC COUNTRIES SPEND LESS THAN ONE-FIFTH OF TOTAL GOVERNMENT EXPENDITURES ON SOCIAL PROTECTION



Source: Asian Development Bank (ADB), Key Indicators for Asia and the Pacific 2017 (accessed in July 2018).

Note: The latest data for Fiji, Japan, Republic of Korea, Maldives, Samoa, Singapore, Sri Lanka, Timor-Leste, and Uzbekistan, are from 2015; latest data for India are from 2014; latest data for Brunei Darussalam are from 2012; latest data for Vanuatu are from 2004. The earliest data for Bhutan and Timor-Leste are from 2007; earliest data for Uzbekistan are from 2010.

Some governments in the region are also designing and implementing universal schemes for specified age groups. For example, in Mongolia, with an investment of only 1.6 per cent of GDP, the Child Money Programme delivers a monthly transfer that provides basic income security to all children below the age of 18⁶. Through its Old Age Allowance, which requires an investment of only 0.3 per cent of GDP, Thailand provides a benefit to 72 per cent of all older persons who are not eligible for a contributory pension scheme.

These universal approaches have had a strong impact on the poverty head count ratio. Mongolia's investment of 1.6 per cent has reduced the extreme poverty head count ratio at \$1.90 a day by 90 per cent, and in Thailand it reduced extreme poverty by 88 per cent.⁷

However, these universal schemes are exceptions in the Asia and Pacific region, which leaves some 60 per cent of all people without adequate social protection coverage.⁸ Children are the most excluded group, with only 21 of 49 countries offering benefits to children and families; this lack of coverage has contributed to high levels of stunting, malnutrition and child mortality in the region.⁹ Moreover, nearly half of all older persons in the region do not receive a pension and less than one third of the labour force actively contributes to a pension.¹⁰ Coverage among persons with disabilities is even lower. Among working-age adults, only one in five receive unemployment benefits when unemployed or underemployed.¹¹

INVESTING TO CLOSE GAPS IN SOCIAL PROTECTION COVERAGE

These gaps in social protection coverage reflect not only the relatively low levels of investment in tax-financed schemes in the Asia-Pacific region, but also the region's preference for poverty targeting, which often relies on the incorrect assumption that funds can be effectively channelled to the poor, even when reliable household income data are not available.

In contrast, in Latin America and the Caribbean, where governments invest more in inclusive tax-financed schemes, nearly 70 per cent of the population enjoys access to social protection and in Europe the coverage is 95 per cent.¹²

Finding fiscal space and prioritizing social protection is a matter of political will rather than resources.

The first step towards building social protection floors usually involves providing a minimum level of basic income security for children, older persons and working-age adults in vulnerable situations. Following this approach, governments can close gaps in basic social protection coverage with a relatively low investment of 1 to 2 per cent of their country's GDP.

Figure 2 illustrates the levels of investment required for developing inclusive social protection systems across 13 countries in Asia and the Pacific using 1 per cent and 1.5 to 2 per cent of GDP respectively.¹³

An investment of 1 per cent of GDP could cover a pension for all citizens from the age of 70 years, alongside disability benefits for children and adults, and a child benefit for all children aged 0–4 years. The old-age pension and disability benefit transfers would be paid at a value of 10 per cent of GDP per capita, and the child benefit would be paid at a value of 4 per cent of GDP per capita.

With an investment of 1.5 to 2 per cent of GDP with the same value of transfers would extend the child benefit to children up to the age of 12 years and lower the eligibility age of the old-age pension to 65 years.

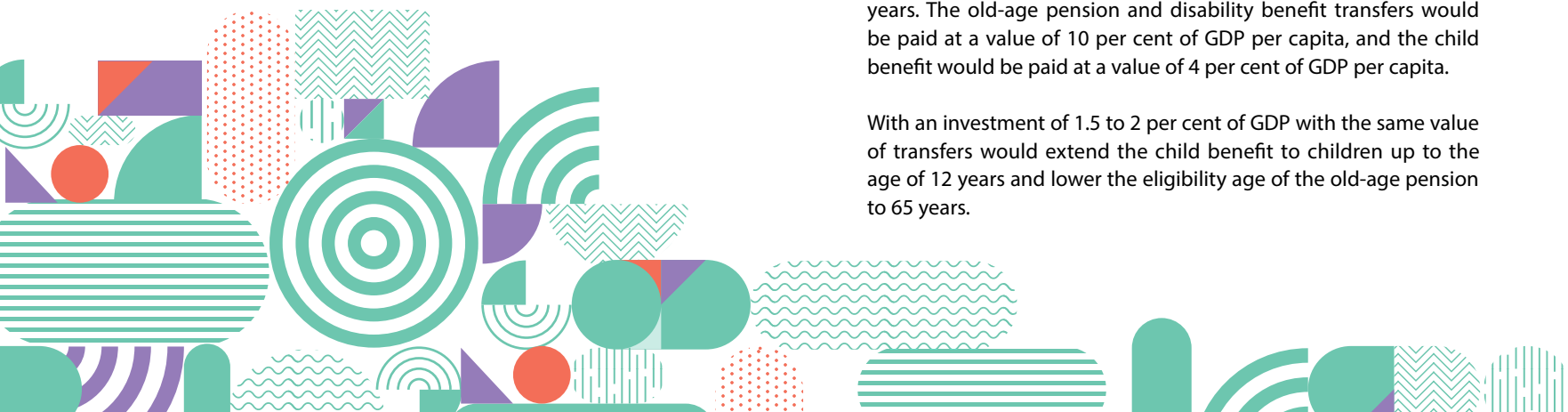
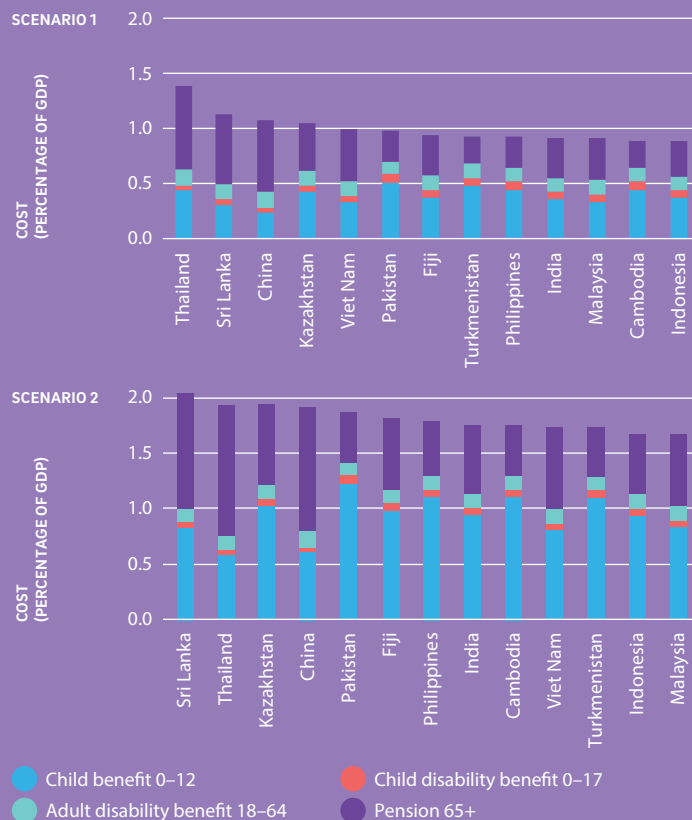


FIGURE 2 INVESTMENT SCENARIOS TO STRENGTHEN INCLUSIVE SOCIAL PROTECTION IN SELECT COUNTRIES IN ASIA AND THE PACIFIC



Source: Calculations by Development Pathways based on 2018 data from IMF's World Economic Outlook database, retrieved from <https://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx> and UNDESA World Population database, retrieved from <https://population.un.org/wpp/>.

These calculations show that investing in inclusive social protection covering the life course is affordable. There is little correlation between the wealth of a country and its level of investment in social protection. Just as most advanced social protection systems across the globe were initiated at a time when these countries were poor, there are low-income countries in the Asia-Pacific region that invest more GDP per capita in social protection than wealthier countries in the region.

For example, in spite of a GDP per capita of only US\$2,500, Nepal invests 1.3 per cent of GDP in its tax-financed social protection system, while Pakistan invests only 0.6 per cent of GDP despite a GDP per capita of US\$5,200.¹⁴ Similarly, while Georgia invests 6.9 per cent of GDP and has a GDP per capita of US\$10,000, Indonesia invests just over 0.8 per cent of GDP yet has a GDP per capita of US\$11,600.¹⁵ Investments in social protection systems usually start small, with investments increasing and systems expanding gradually over time along with increased political commitment.



HOW TO INCREASE THE FISCAL SPACE FOR TAX-FINANCED SOCIAL PROTECTION

Investments in social protection need to be solidly grounded in domestic, primarily public financing. An effective financing framework should be consistent with the Sustainable Development Goal Target 1.3, which requires all governments to finance national social protection floors¹⁶ that provide income security for children, working-age adults, older persons and essential health care services, to end poverty in all its forms everywhere by 2030.

The Addis Ababa Action Agenda¹⁷ provides a framework for financing sustainable development by aligning all financing flows and policy actions with economic, social and environmental priorities. It identifies social protection as one of seven key areas for implementing the 2030 Agenda for Sustainable Development and for ending poverty. It also highlights the importance of social protection for all, including social protection floors, with a focus on ensuring the inclusion of those furthest behind, and encourages countries to consider setting nationally appropriate spending targets for quality investments in essential public services for all.

Governments can use a variety of methods to mobilize resources to ensure financial, fiscal and economic sustainability of national social protection floors, taking into account the contributory capacities of different age and populations groups. As also outlined in ESCAP's *Policy Brief on Financing Social Protection*,¹⁸ such methods may include more efficient tax collection and enforcement of contribution obligations, but also reprioritizing expenditures and finding new revenue bases.

Strategies for resource mobilization include: increasing tax revenues; re-allocating public expenditures; drawing on official development assistance; fighting illicit financial flows; tapping into reserves; borrowing/re-structuring debt; adapting the macroeconomic framework.

INCREASING TAX REVENUES

Government tax revenues are relatively low in many countries in the Asia-Pacific, with a regional average of 19.6 per cent of GDP, compared to an average of 34 per cent in OECD (Figure 3). Important to note is that in Asia and the Pacific, less than one third of the total tax revenue is collected from income, profits and capital gains.

A progressive tax policy and effective wealth and income tax collection allows governments to invest in social infrastructure, including social protection, and help address prevailing inequalities. Progressive pro-poor taxation systems grounded in the concept of solidarity emphasize taxing personal income, wealth and capital gains, rather than relying on broad support from consumption, such as VAT, which is usually regressive and anti-poor.¹⁹

Many countries struggle to generate higher tax revenues as a large part of the labour force works in the informal economy. In addition to taxing income it is therefore important to move towards more formal jobs and develop strategies to broaden the tax base. In raising tax revenues, governments can explore additional taxes on corporations, inheritance, property and wealth.

The taxation on mining and natural resource extraction can generate fiscal space to fund social protection for many natural resource-rich low and middle-income countries. Governments may raise revenues either by directly extracting the natural resources through a state-owned enterprise, joint-ventures or other forms of co-extraction, or by selling off the exploitation rights and taxing the profits, both of which can provide revenues for social investments (see Box 1).

FIGURE 3 TOTAL TAX REVENUE IN ASIA-PACIFIC AS SHARE OF GDP, 2015



Source: International Center for Tax and Development (2016) and OECD (2013) revenue statistics. For all countries, the most recent data entries between 2011 and 2013 were reported.

BOX 1 TAXING MINING AND NATURAL RESOURCE EXTRACTION

The Government of Mongolia has been supporting the financing of old-age pensions and child and family benefits through the Human Development Fund (HDF), established in 2009 with the aim of accumulating excess revenues from the mining sector, and redirecting them towards the economic and human development of the country. In addition to pensions, the HDF is currently being used for providing health-care, housing and educational benefits to Mongolian citizens. Due to lack of fiscal space, Mongolia has also considered the establishment of a pension reserve fund, which will be used to invest a percentage of excess mining royalties.

Source: ESCAP (2014). *Financing Social Protection. Policy brief number 49*. Bangkok.

Another option may be to increase so-called sin taxes on goods recognized as harmful. WHO estimates that a 5–10 per cent increase of the tobacco tax rate could net up to US\$1.4 billion per annum in additional revenue in low-income countries and US\$5 billion in middle-income countries. Such earmarked taxes have contributed to financing the social sector in several countries.²⁰ Already in 1982, the Republic of Korea introduced a tax on alcohol, tobacco, interest and dividend income, as well as on the banking and insurance industry, earmarked for education.²¹

With considerable inefficiencies in existing tax collection mechanisms in many countries in the region, increasing tax effort is also important for increasing revenues. The tax effort measures the difference between the amount of tax collected and the amount that could be collected if all tax rates were perfectly applied to the full tax base. If select countries in the Asia-Pacific increased their tax effort to the average of all lower-middle-income countries, theoretically overall tax revenues could be increased by 18.6 per cent without increasing the tax rate.²²

REALLOCATING PUBLIC EXPENDITURES

Reallocating public expenditures requires a replacement of high-cost and low-impact investments with investments that can generate larger socioeconomic impact. It also involves eliminating spending inefficiencies and tackling corruption.

One such area of expenditure is subsidies, for example on oil, electricity, agricultural inputs or food. Many subsidies disproportionately benefit the more affluent, as they are the largest consumers of many of the subsidized goods, while those living in poverty tend to benefit the least. Countries in Asia and Pacific spend considerable resources on fuel subsidies, which are often regressive and have environmental consequences as they incentivize fuel-intensive production.²³

The removal of subsidies may require measures to mitigate economic impacts and public opposition to their removal. For instance, since 2005, Indonesia has occasionally offered short-term cash transfer schemes when the oil subsidy has been reduced, while, in 2010, Iran established a universal basic income as compensation for its reform of the oil subsidy.²⁴ Replacing subsidies with investment in conventional life cycle social protection schemes is the long-term strategy to build inclusive social protection systems, benefiting both the poorest and those in the middle-income strata.

There is a range of other options for reallocating spending, including some from within the social protection sector. Some countries implement a large number of small social protection and poverty reduction programmes, often fragmented and overlapping in nature. Such schemes should be replaced by inclusive social protection schemes for increased efficiency and reduced spending.

TACKLING ILLICIT FINANCIAL FLOWS

Illicit financial flows involve capital that is illegally earned, transferred or used, and include, among other things, traded goods that are mispriced to avoid higher tariffs, wealth funnelled to off-shore accounts to evade income taxes and unreported movements of cash.

Developing countries lost approximately US\$6.6 trillion in illicit outflows between 2003 and 2012 (an annual average of 3.9 percent of GDP), which is up to 10 times more than official development assistance (ODA) inflows.²⁵ Curtailing illicit financial flows has the potential to generate considerable additional resources for socioeconomic investments, including social protection.²⁶

TAPPING INTO FISCAL AND CENTRAL BANK FOREIGN EXCHANGE RESERVES

Fiscal and central bank foreign exchange reserves offer potential sources of financing investments of social protection. Fiscal reserves are accrued through government budget surpluses, the profits of state-owned companies, privatization receipts or other government net income. Foreign exchange reserves, on the other hand, are accumulated through foreign exchange market interventions by central banks within the context of current account surpluses and/or capital inflows. While fiscal reserves provide additional fiscal resources for the government and can be spent without incurring debt, central bank reserves are financed by issuing bonds or currency and do not constitute “free fiscal assets” since they have counterpart liabilities (i.e. currency or bonds). Fiscal and foreign exchange reserves present creative possibilities for governments to enhance fiscal space for social protection although a careful assessment of their potential impact on monetary expansion or public debt impact is warranted.

There are a number of examples of foreign exchange reserves being used to finance local development.²⁷ For example, India uses a proportion of its foreign reserves to support infrastructure investment, by creating two subsidiaries that borrow foreign exchange reserves from the central bank.²⁸ A similar approach could be used for social protection investments.



BORROWING OR RESTRUCTURING DEBT

Some countries have the potential to borrow, through loans or bond issues, with minimal impact on their fiscal situation. Others already have large debts and need better debt management. Many countries in the Asia-Pacific region continue to take loans from international financial institutions to fund social protection schemes including, in recent years, Bangladesh, Indonesia, Pakistan, the Philippines, and Viet Nam.²⁹ However, international financial institutions can impose conditions on countries for release of the funds which, if poorly designed, can distort national policy processes.

Debt restructuring is the process of reducing existing levels of debt or debt service charges. Restructuring of sovereign debt can be achieved through: (i) renegotiating the debt; (ii) debt relief/cancellation, for example under the Heavily Indebted Poor Countries Initiative introduced in 1996; or (iii) debt swaps/conversions. Some countries have also repudiated or defaulted on the repayment of the debt, as was the case in Iceland and Iraq.³⁰ The Addis Ababa Action Agenda affirms the importance of debt restructuring being timely, orderly, effective, fair and negotiated in good faith.

ADOPTING INCLUSIVE MACROECONOMIC FRAMEWORKS

Macroeconomic policy places a strong emphasis on short-term stabilization measures, such as controlling inflation and fiscal deficits, as part of broader efforts aimed at liberalizing economies, integrating them into global markets and attracting investment. Governments may also adopt a more accommodating macroeconomic framework, allowing for higher budget deficits and levels of inflation without jeopardizing macroeconomic stability.

As part of the response to the global financial crisis of 2007-2008, there has been a growing recognition of the need to ease budget constraints and allow for an increasing degree of deficit spending, especially to support socially relevant investments and employment-generating economic growth.



DRAWING ON DEVELOPMENT ASSISTANCE

In the long-term all social protection systems need to rely on domestic resources in order to be sustainable. The central role of domestic public resources for the financing of sustainable development is also reaffirmed by the Addis Ababa Action Agenda. However, official development aid (ODA), as a transitional co-financing or to introduce pilot projects, can provide a source of financing in the short term, as in the case of the Benazir Income Support Programme (BISP) in Pakistan whereby the United Kingdom provided some £300 million in financial aid and technical assistance, complementing core government funding that covered 87 per cent of the programme budget.³¹

While the 2005 Paris Declaration on Aid Effectiveness emphasized the importance of ownership and mutual accountability as key to effective development aid, donor assistance can come with a number of challenges including transaction costs, limited predictability and sustainability of a scheme, macroeconomic impacts, tied aid, lack of policy coherence and other conditions as imposed by donors. Further, when donors fund social protection programmes, accountability is often to the donor rather than to citizens – programmes thus run the risk of prioritizing donor preferences ahead of the needs of people.

FINANCING SOCIAL PROTECTION FROM CONTRIBUTIONS

While it is essential to have tax-financed social protection schemes in place to reach those most in need, it is important to complement these with schemes to which those in formal employment can contribute. Many countries in the region have established contributory social protection schemes to provide people with regular income transfers for particular contingencies, such as injury, disability, unemployment, maternity and retirement.

There are two main types of contributory schemes: (i) social insurance schemes that are managed or overseen by governments and incorporate some form of cost-sharing and solidarity between members; and, (ii) insurance schemes that are managed by the private sector and regulated by governments.

Social insurance is often designed as:

- pay-as-you-go schemes, where benefits are paid from the contributions of current contributors; or
- funded schemes, where contributions are invested with the aim of growing the value of the overall fund.
- The values of benefits are often calculated as:
 - defined benefits, where the value of the future benefit is known through a formula and often linked to previous salary; or
 - defined contributions, where the value of the future benefit depends on the amount of contributions paid in to the scheme as well as the return the investment.



BOX 2 URUGUAY'S 'MONOTAX'

To combine contributory social insurance schemes and tax-financed programmes, Uruguay has designed a unified system known as a “monotax”. It is a system of cross-subsidization, based on the principles of solidarity, inclusiveness and equity. Contributions are made on the basis of people’s ability to pay, and benefits are disbursed following equitable, needs-based criteria.

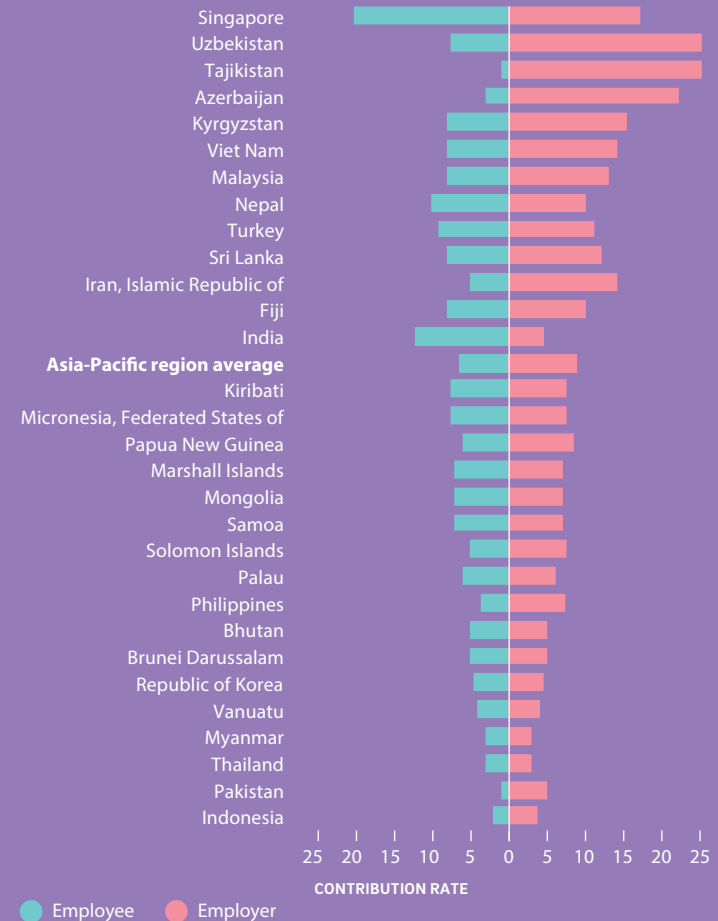
This innovative solution has served to overcome the segmentation in benefit schemes between salaried workers in the formal sector and those working in the informal economy.

Source: Ocampo, J.A. and N. Gomex Arteaga (2016) Social Protection Systems in Latin America, ILO ESS, Working Paper No. 52.

In the Asia and Pacific region only one out of five unemployed working-age adults receives unemployment benefits.³² This wide gap in coverage is largely due the size of the informal sector, which comprises 60 per cent of the labour force in Asia and the Pacific.³³ It is difficult for informal workers to enter into social insurance schemes as wages are often too low and volatile and there are no contributions from the employer. As an effort to extend coverage to all working-age adults, Uruguay introduced a ‘monotax’ that combines contributory and tax financed benefits (see Box 2).

When designing the financial structure of contributory schemes, the level of contributions should be set high enough to provide an adequate benefit, but not too high to threaten the viability of business. In Asia and the Pacific, the average contribution towards old-age pension schemes is 6.4 per cent from the employee and 8.9 per cent from the employer.³⁴ These are lower than contribution levels in Europe where average contributions are 7.8 per cent for employees and 11.5 per cent for employers.³⁵ As Figure 4 shows, contribution rates vary greatly between countries and are particularly high for employers in several North and Central Asian countries.

FIGURE 4 CONTRIBUTION RATES TO SOCIAL INSURANCE OLD-AGE PENSION AND PROVIDENT FUND SCHEMES IN ASIA AND THE PACIFIC, LATEST YEAR AVAILABLE



Source: ILO, World Social Protection Report 2017–2019.

Conclusion

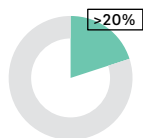
Social protection is an essential component of any successful and sustainable society. Inclusive life cycle social protection systems are also affordable. While most countries in the Asia-Pacific have increased their investments in social protection, many countries should invest more to close existing coverage gaps and thereby reduce poverty, vulnerability and inequality.

Fiscal space to finance expansions in social protection can be identified and include a wide range of options. Whether governments choose to invest in social protection is a political choice, rather than a fiscal one.

Did you get that?

KEY TAKEAWAYS FROM THE POLICY GUIDE "HOW TO FINANCE INCLUSIVE SOCIAL PROTECTION"

Current investments in social protection in Asia and the Pacific are low but increasing



Most Asia-Pacific countries spend less than one-fifth of total government expenditures on social protection. Many countries need to invest more to close existing coverage gaps and reduce poverty, vulnerability and inequality.



To reach the most vulnerable groups it is especially important to invest in tax-financed social protection.



Finding fiscal space and prioritizing social protection is a matter of political will rather than resources and there is little correlation between the wealth of a country and its level of investment in social protection.



Investments in social protection need to be solidly grounded in domestic, primarily public financing.

Ways to increase the fiscal space for tax-financed social protection:

- a Increasing tax revenues:** tax revenues are comparatively low in the region. Countries can therefore consider progressive pro-poor taxation policies that tax personal income, wealth and capital gains as well as develop strategies to broaden the tax base through the creation of more formal jobs. Other ways to increase tax revenues include taxation on mining and natural resource extraction, sin taxes and increasing efficiency of tax collection.
- b Reallocating public expenditures** can include the removal of subsidies, reallocation of investments between sectors, or within the social protection sector to replace a large number of small social protection schemes with inclusive social protection schemes that can generate larger socioeconomic impact.
- c Tackling illicit financial flows,** tapping into fiscal and central bank foreign exchange reserves, borrowing or restructuring debt present other potential possibilities to enhance fiscal space.
- d Adopting inclusive macroeconomic frameworks** allowing for higher budget deficits and levels of inflation without jeopardizing macroeconomic stability.
- e Drawing on development assistance** as a transitional co-financing or to introduce pilot projects.

Social protection financed from contributions is important to complement tax-financed social protection

Social insurance is often designed as pay-as-you-go schemes, where benefits are paid from the contributions of current contributors, or funded schemes, where contributions are invested to grow the value of the overall fund.

The values of benefits are often calculated as:

- **defined benefits**, where the value of the future benefit is known; or
- **defined contributions**, where the value of the future benefit depends on contributions paid and the return on the investment.

When designing the financial structure of contributory schemes, the level of contributions should be set high enough to provide an adequate benefit, but not so high it discourages people from contributing.

Social protection is part of the social contract

Financing social protection is the responsibility of the State. A broad political consensus that positions social protection as a vital investment in human capital is essential to ensure long-term financing and national ownership.

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How to Finance Inclusive Social Protection

This is the fourth in a series of policy guides developed to support policymakers and practitioners in Asia and the Pacific in their efforts to strengthen social protection. This guide outlines the trends of social protection spending in the region, and suggests options for increasing fiscal space for tax-financed social protection.

The first guide explores the basic principles of why social protection is needed; the second explains the critical steps in designing social protection schemes; and, the third focuses on how to effectively implement social protection schemes.

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