

# OPTIONS TO CREATE ADDITIONAL FISCAL SPACE FOR ADHERENCE TO THE SOCIAL PROTECTION AGENDA OF THE SDG

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ADB-ADBI Learning Program on Financing Social Protection for Sustainable Development Goals

15-16 February 2017, Seoul, Republic of Korea

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- Financing options
- Bottom line



# BACKGROUND

- Cichon and Hagemeyer (2007): closing the social protection gap demands at least US\$380 billion
- ILO recommendation R202.
- High level panel (Bachelet, 2011)
  - Close the gap with progressive taxation.
- Taxation is limited, alternatives must be considered
  - Monetary policy?
  - Foreign exchange reserves? (Ortiz et al., 2011).



# BACKGROUND

- As Chapter 1 shows, filling the social protection gap of the SDGs implies an increase in spending by 30% in many countries.
- This chapter shows that the social protection gap can be filled by reducing energy subsidies and further tax efforts.
- Increase conventional tax rates is an option of last resort.



# Creating fiscal space

- Who will benefit directly from closing the gap.
  - This is a fundamental question.
  - It determines the political economy aspect of taxation towards social protection (social contract).

## **Workers w/ social Insurance**

- Follow the Bismakian model of social insurance.
- Pay direct taxes that fund social protection for workers with no social insurance.

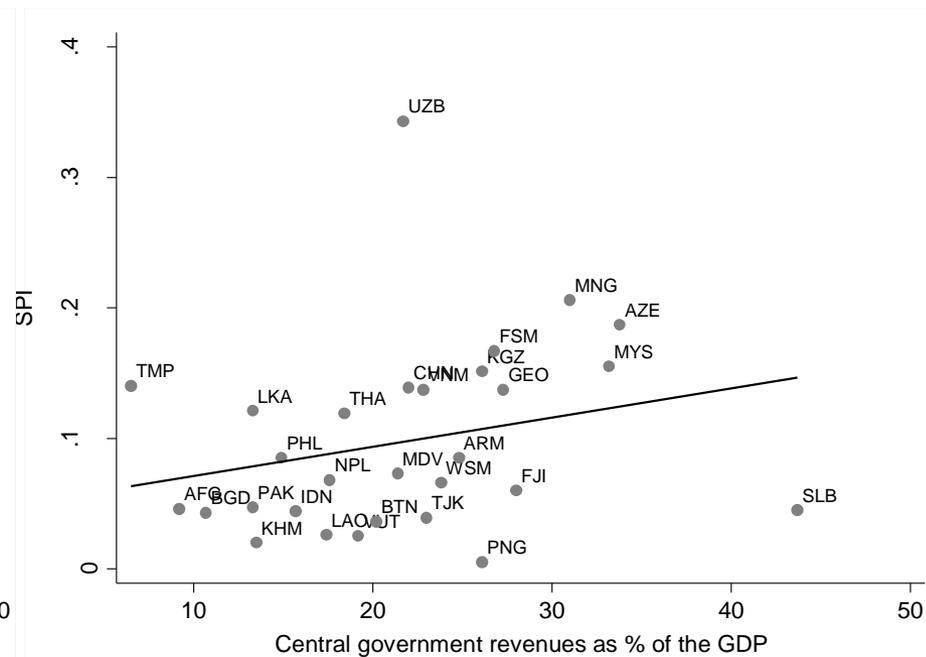
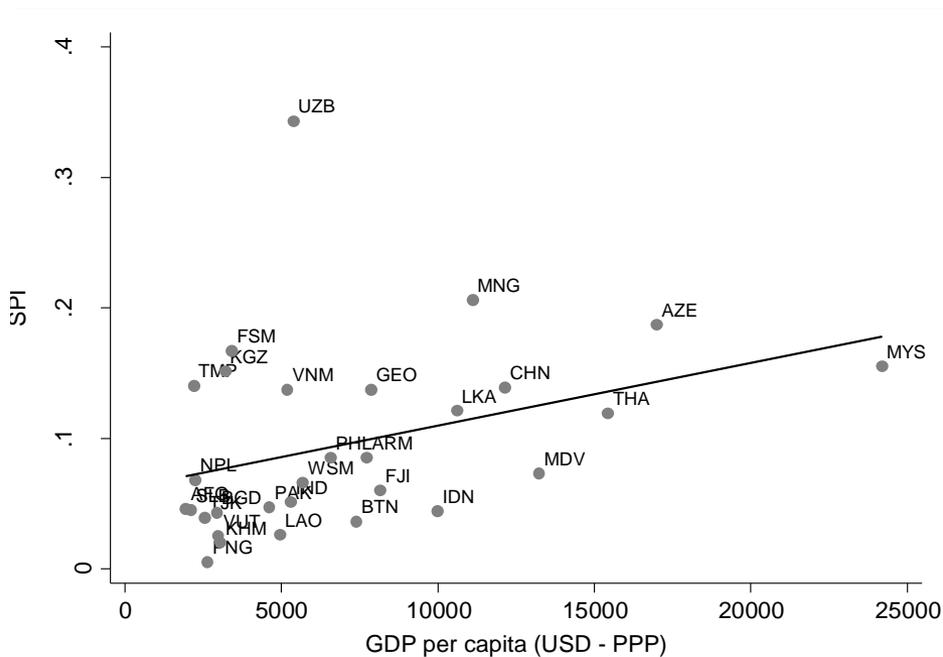
## **Workers w/o social Insurance**

- Unprotected from risks.
- Must be covered with social assistance.
- Financed with general government revenues.



# Creating fiscal space

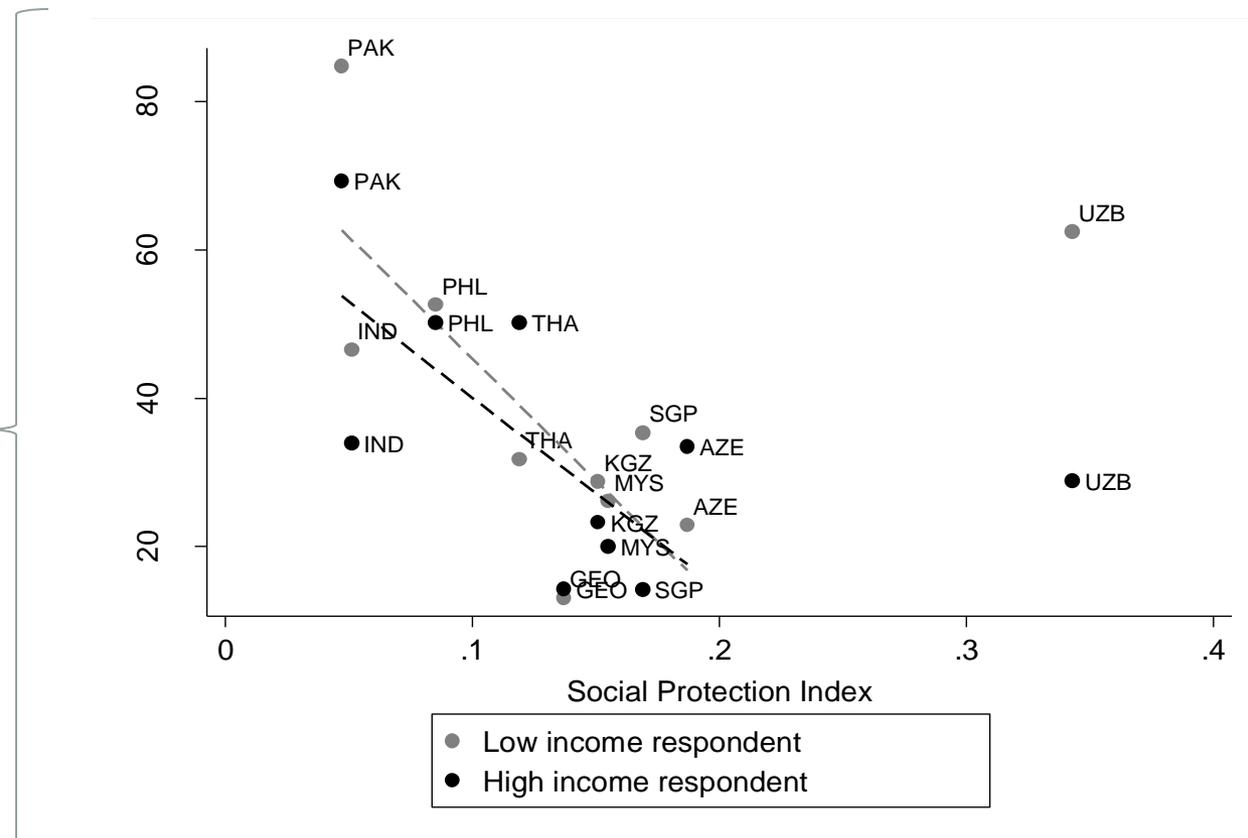
- ADB's Social Protection Index (2013): sets a benchmark of 25% of GDP to be spent on SP.



# Creating fiscal space

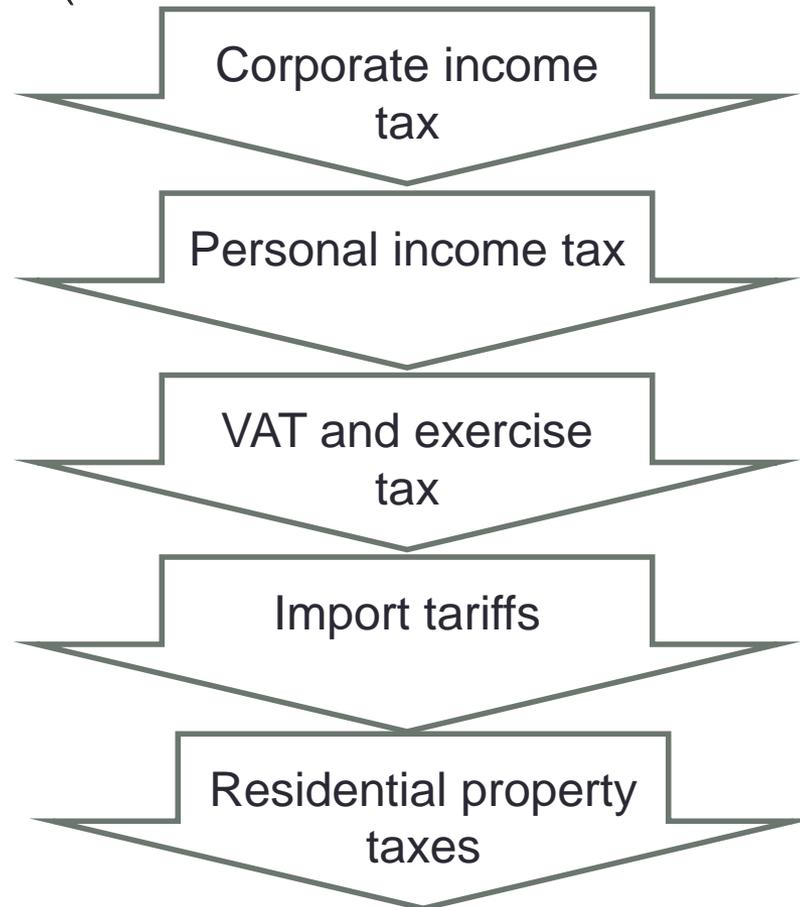
- The scope of taxation to finance social protection.
  - In some contexts social protection has been financed with natural resources rents, no one is taxed at all.

However, the willingness to pay taxes to subsidize the poor shows a decreasing trend with the SPI



# Considerations

- Taxes and growth.
  - There is a consensus on which taxes are more harmful to economic growth (ordered from the most to the least harmful):



# Considerations

- Taxes and growth.
  - Goal 10 of the SDGs establishes a clear mandate to reduce inequalities within and among countries.
  - There is a trade-off between indirect taxation and redistribution.

## Direct taxation

- Can be progressive and pro-poor.
- Investment and economic activity concerns.

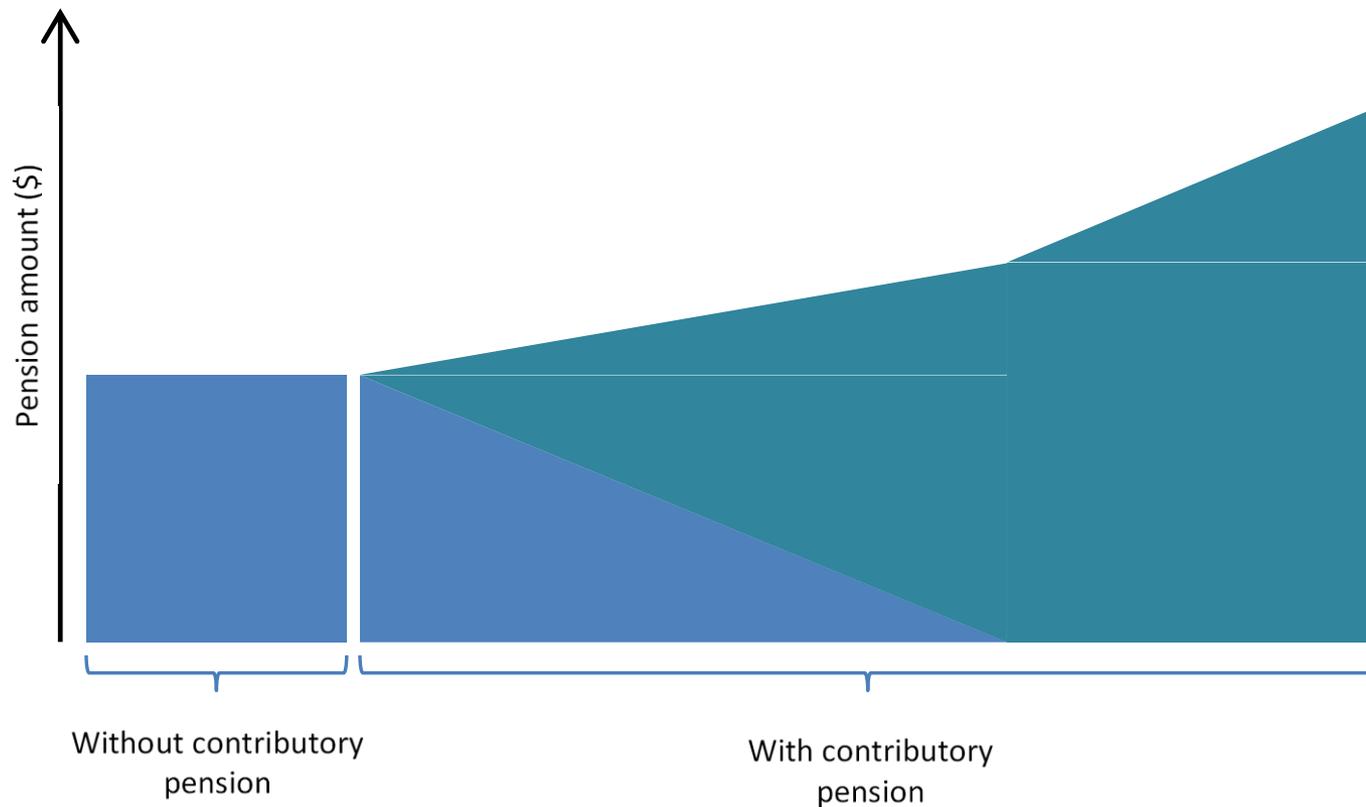
## indirect taxation

- Less harmful for growth.
- Distributive concerns.

- Not all taxes must be progressive. The whole fiscal system must lead to redistributive outcomes.
- → This actually what the SDGs are doing.

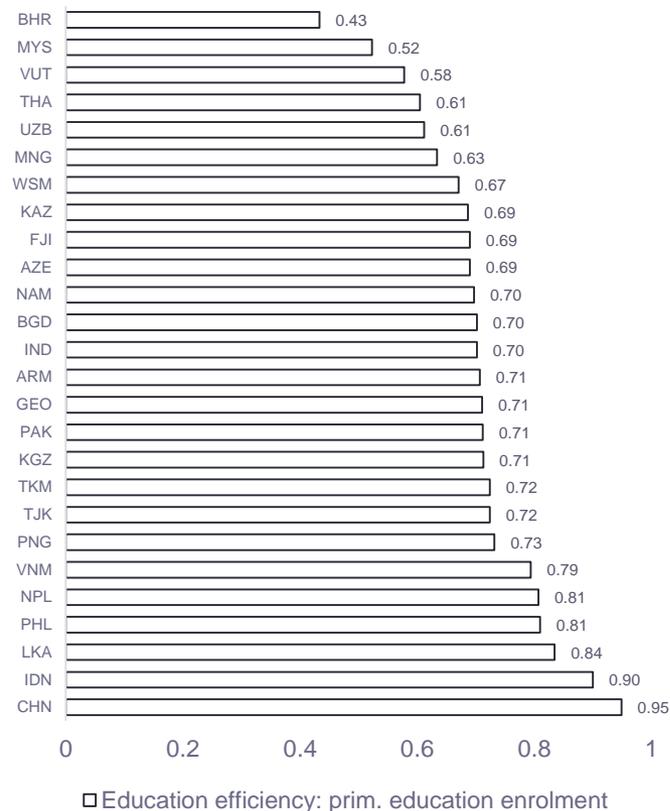
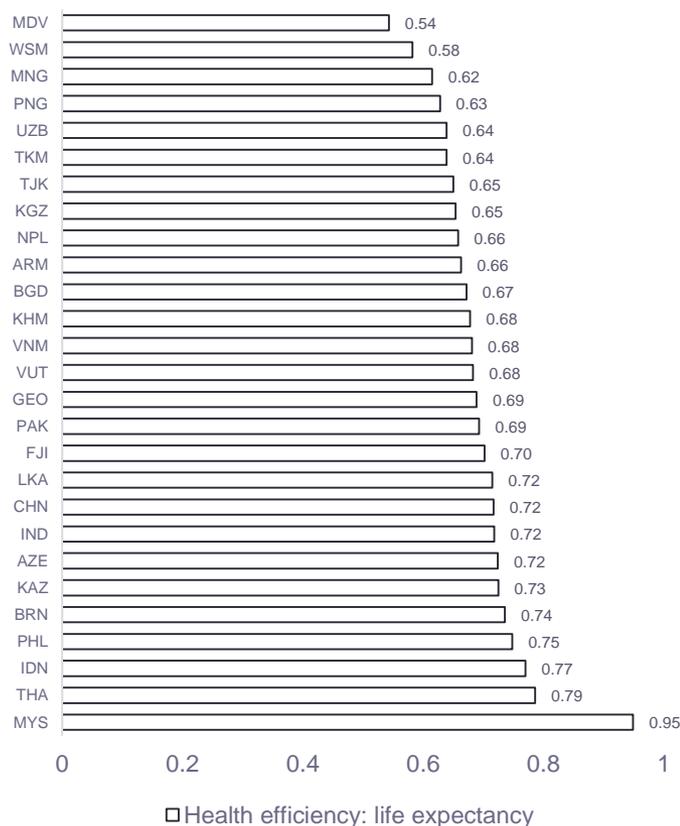
# Considerations

- Redistribution through the pension system in Chile



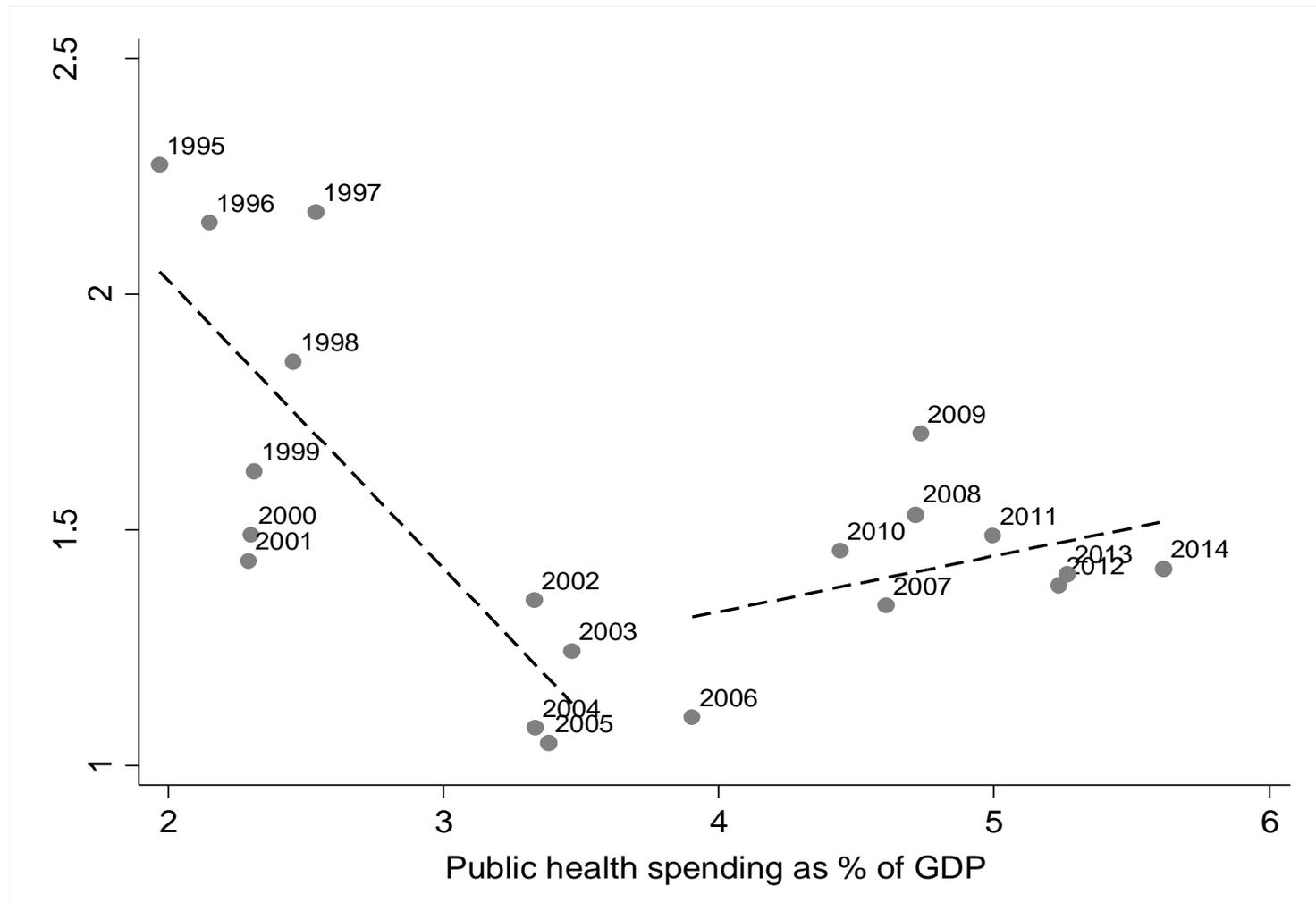
# Considerations

- Spending efficiency, how to optimize outcomes to expand coverage. E.g. health and education spending (Herrera and Pang, 2005)



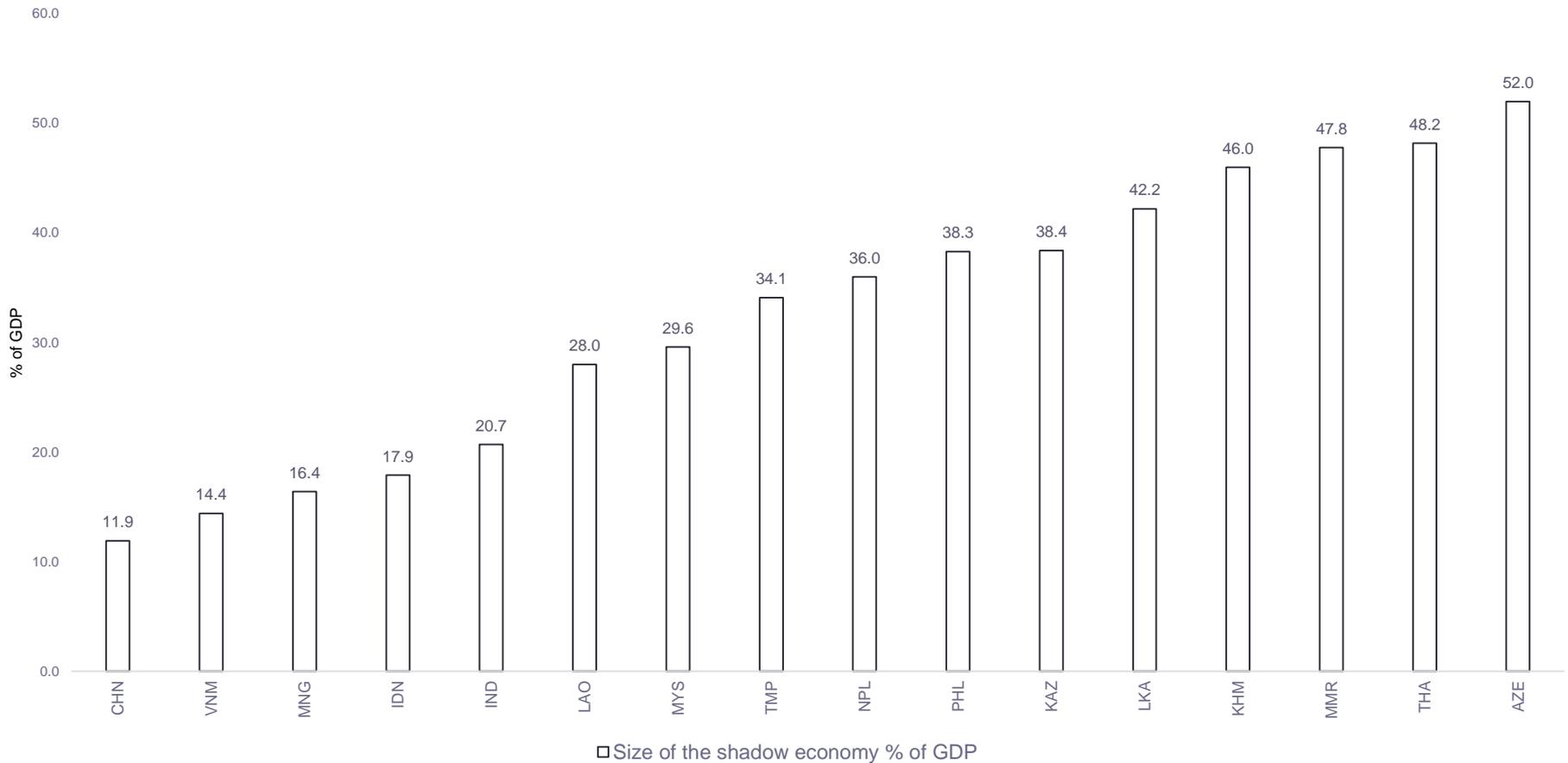
# Considerations

- Spending reallocation in Thailand:



# Considerations

- Shadow economy
  - Determines the extent to which countries fail to collect taxes



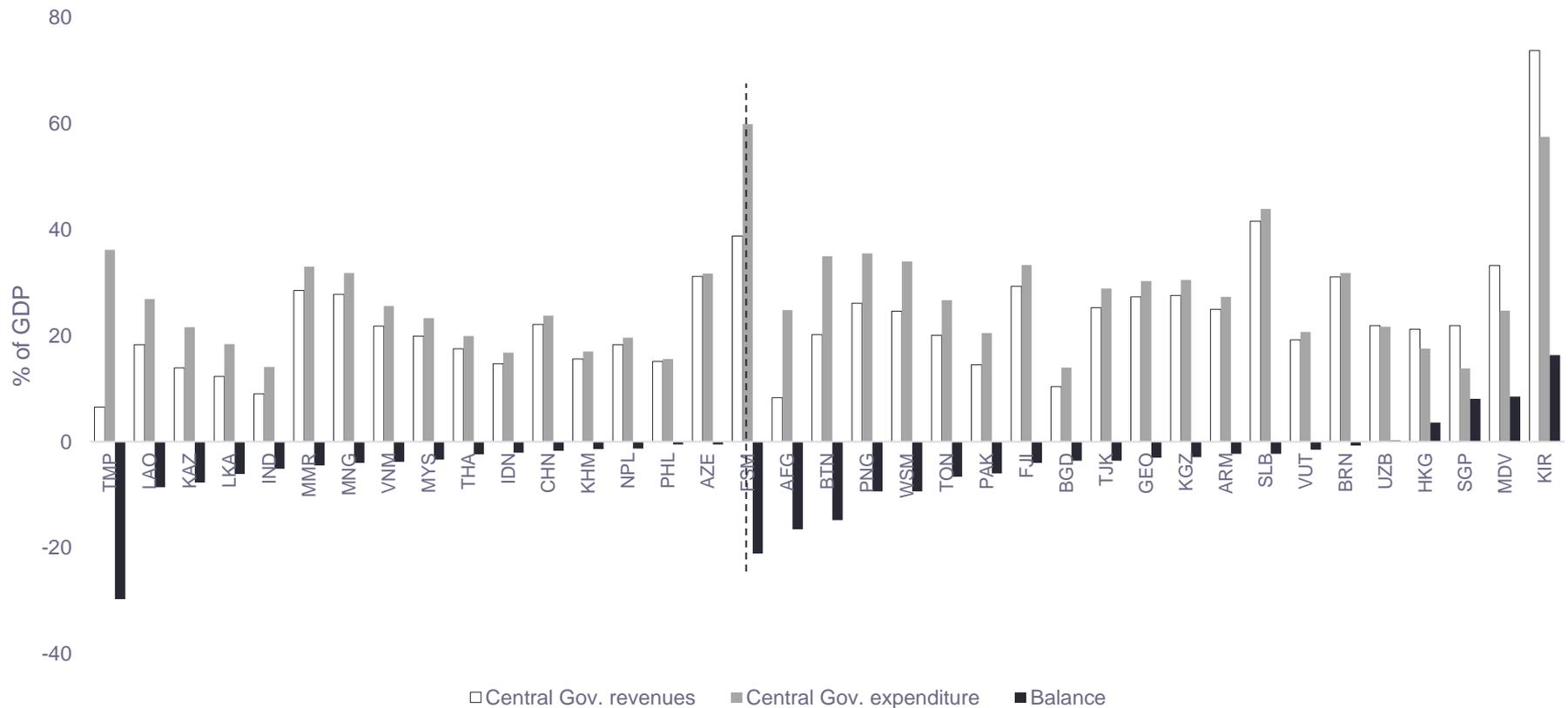
# Considerations

- Tax effort
  - Depends on taxing capacity and actual collection

| Country     | Le et al. (2012) |            | Fenochietto and Pessino (2012) |            |
|-------------|------------------|------------|--------------------------------|------------|
|             | Tax capacity     | Tax effort | Tax capacity                   | Tax effort |
| Azerbaijan  | 25.01            | 1.09       |                                |            |
| Cambodia    |                  |            |                                |            |
| China       | 15.64            | 0.68       | 39.10                          | 0.49       |
| India       | 11.18            | 1.12       | 29.60                          | 0.53       |
| Indonesia   | 15.10            | 1.15       | 28.00                          | 0.47       |
| Kazakhstan  | 14.62            | 0.56       |                                |            |
| Lao PDR     |                  |            |                                |            |
| Malaysia    | 19.38            | 1.12       |                                |            |
| Mongolia    | 15.21            | 2.24       | 41.80                          | 0.82       |
| Myanmar     |                  |            |                                |            |
| Nepal       |                  |            |                                |            |
| Philippines | 15.51            | 0.98       | 23.70                          | 0.58       |
| Sri Lanka   | 14.07            | 1.10       | 21.90                          | 0.64       |
| Thailand    | 17.62            | 1.12       | 36.70                          | 0.50       |
| Timor-Leste |                  |            |                                |            |
| Vietnam     | 14.35            | 1.66       | 36.80                          | 0.66       |

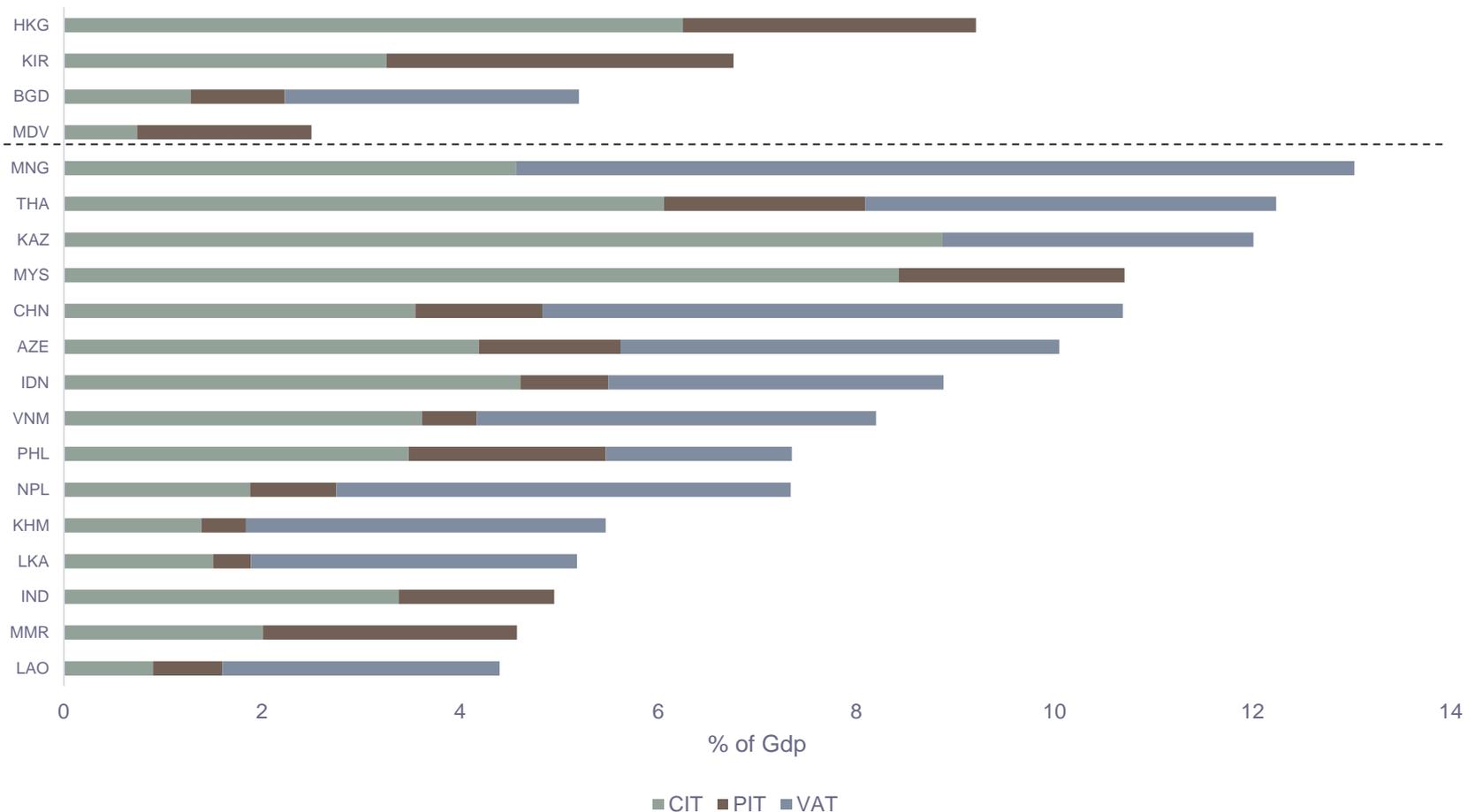
# Options

- Central government revenues and expenditure as percentage of the GDP (circa 2014)



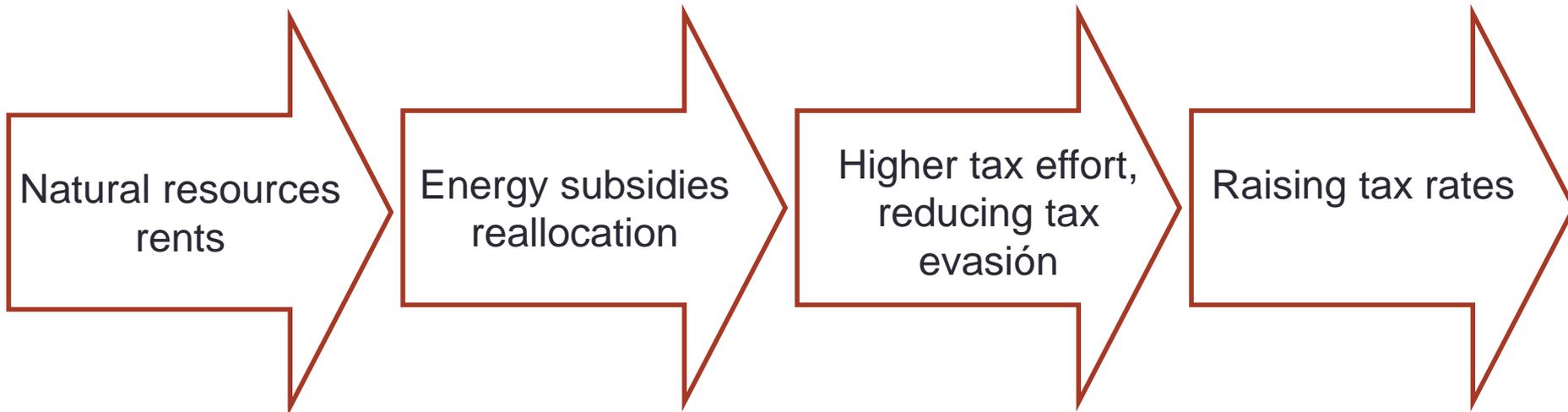
# Options

- Corporate (CIT), personal (PIT) and value added (VAT) tax revenues (circa 2013).



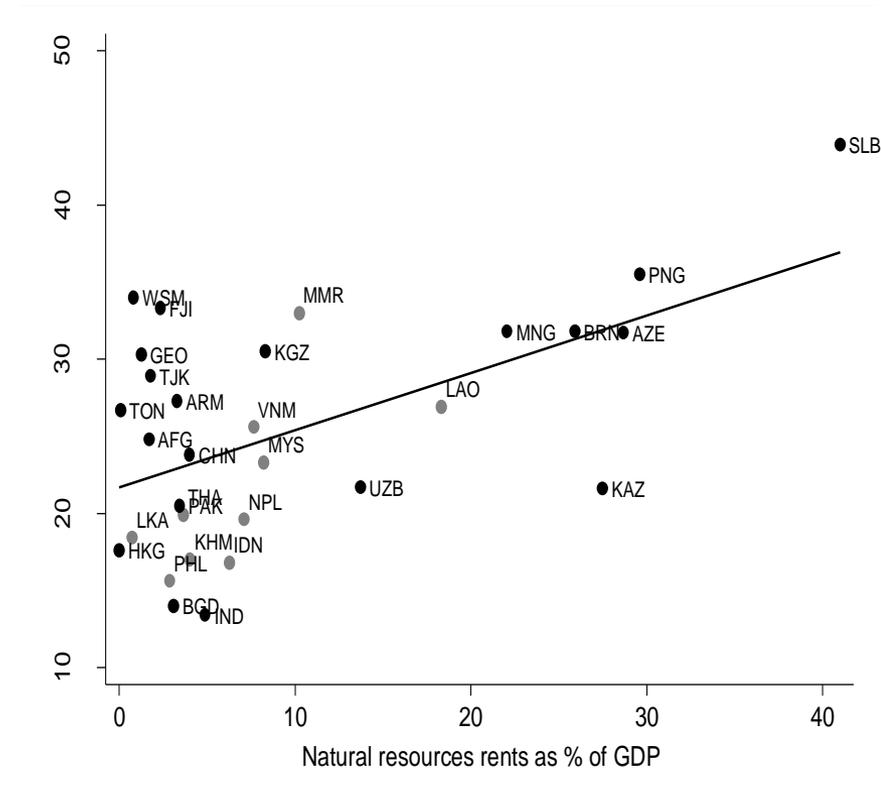
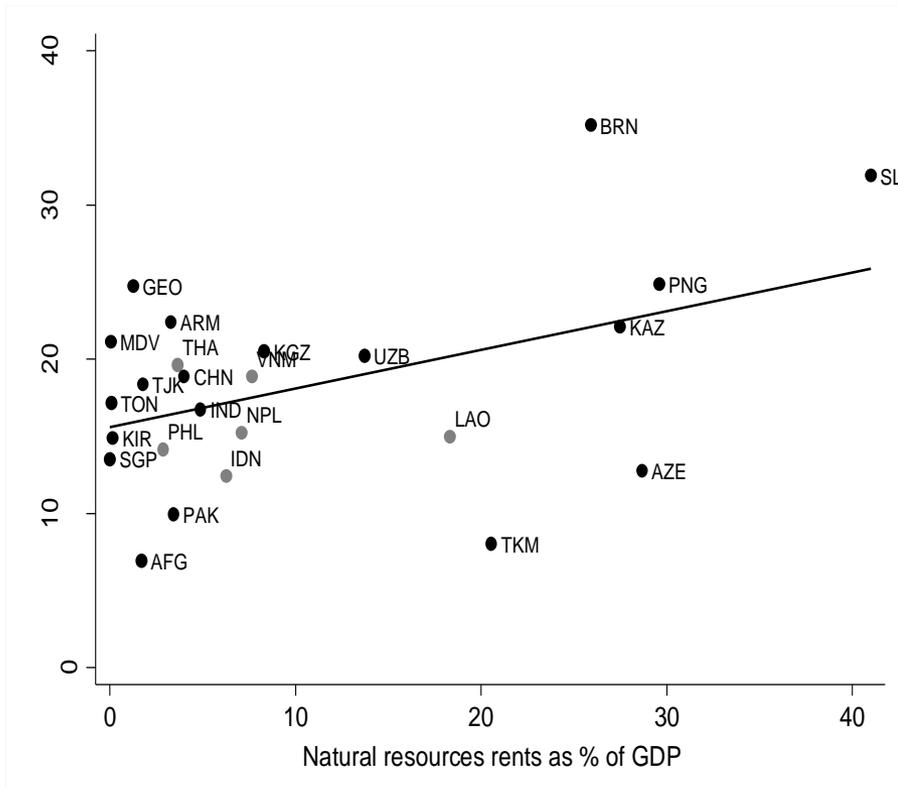
# Options

- Options are ordered from the least to the most distortive:



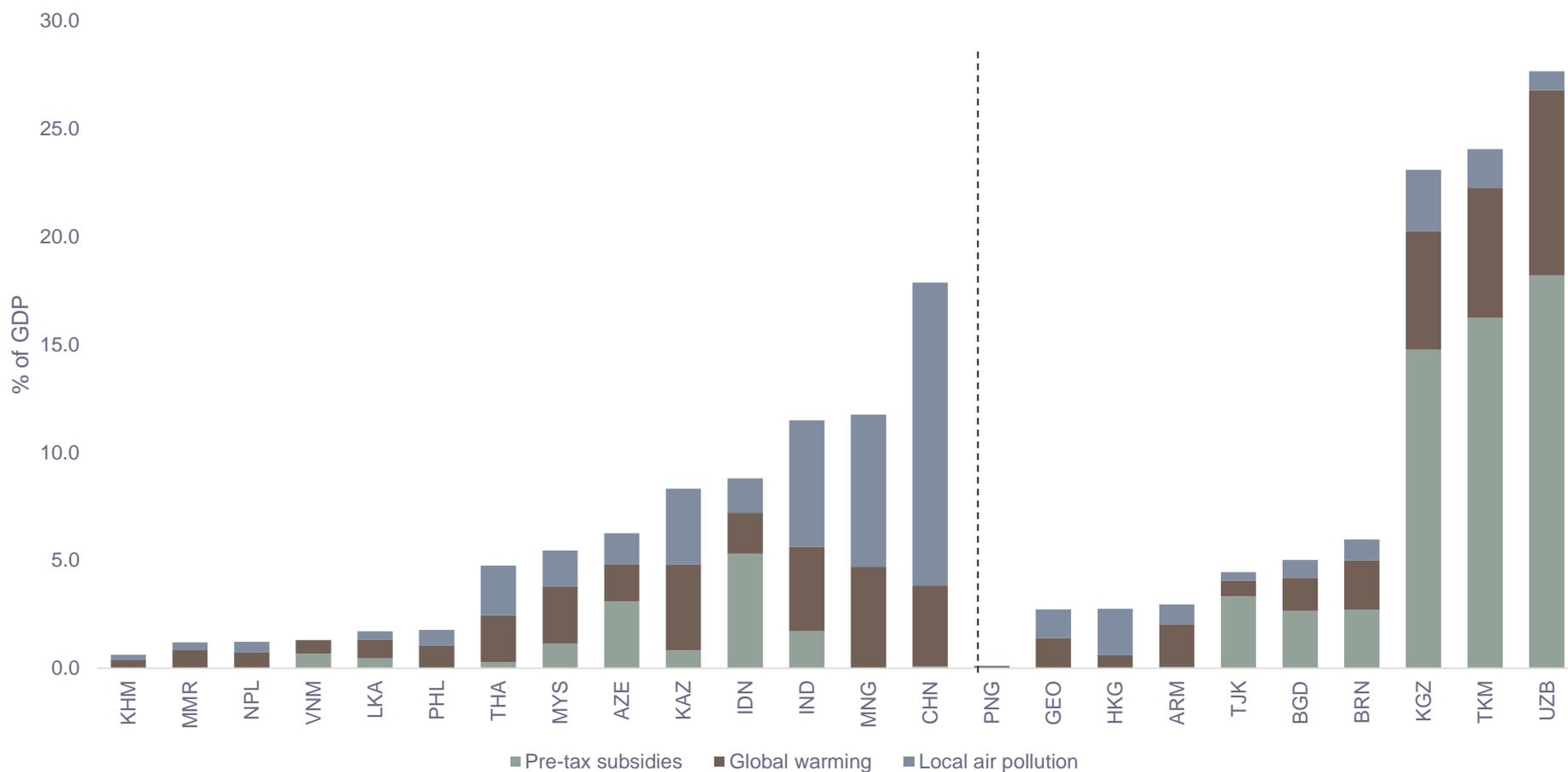
# Options

- Natural resources



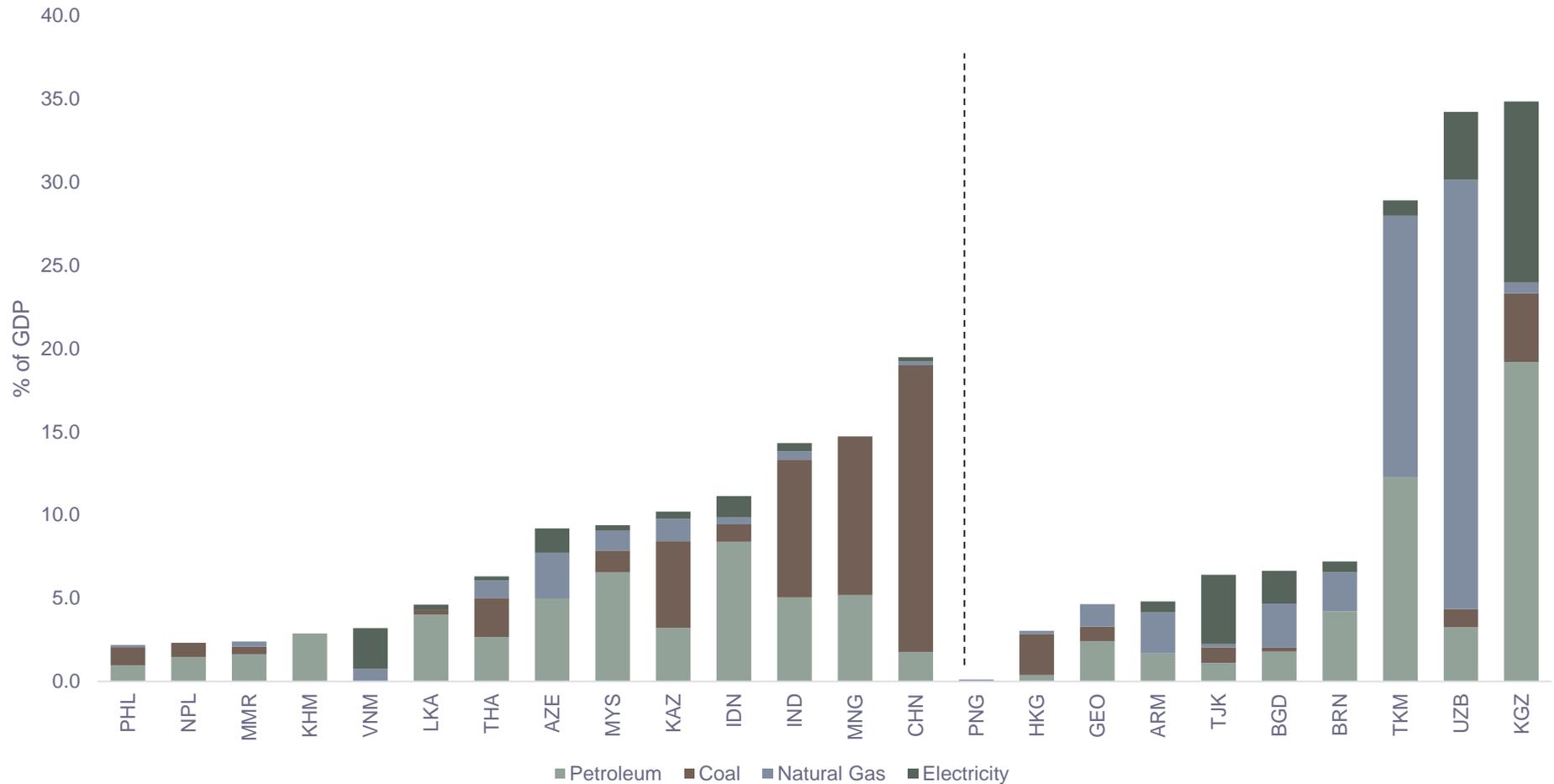
# Options

- Energy subsidies reallocation (by component)



# Options

- Energy subsidies reallocation (by product)



# Options

- Energy subsidies reallocation (by product)
  - Examples:
    - Islamic Republic of Iran: from paying US\$0.40 per gallon of refined fuel in 2010 to US\$1.20 in 2012
    - Creation of a cash transfer scheme, universal coverage.
    - Armenia: state-owned firms producing subsidized electricity.
    - The tariff per kilowatt (hour) was raised from AMD\$10 to AMD\$30.
    - The Poverty Family Benefit was launched in compensation.
    - Indonesia: withdrawal of fuel subsidies.
    - gasoline price rose by 87.5 percent and kerosene by 185.7 percent.
    - Introduction of the CCT, Program Keluarga Harapan (PKH)

# Options

- Tax effort, reducing evasion
  - Estimated forgone tax due to the shadow economy

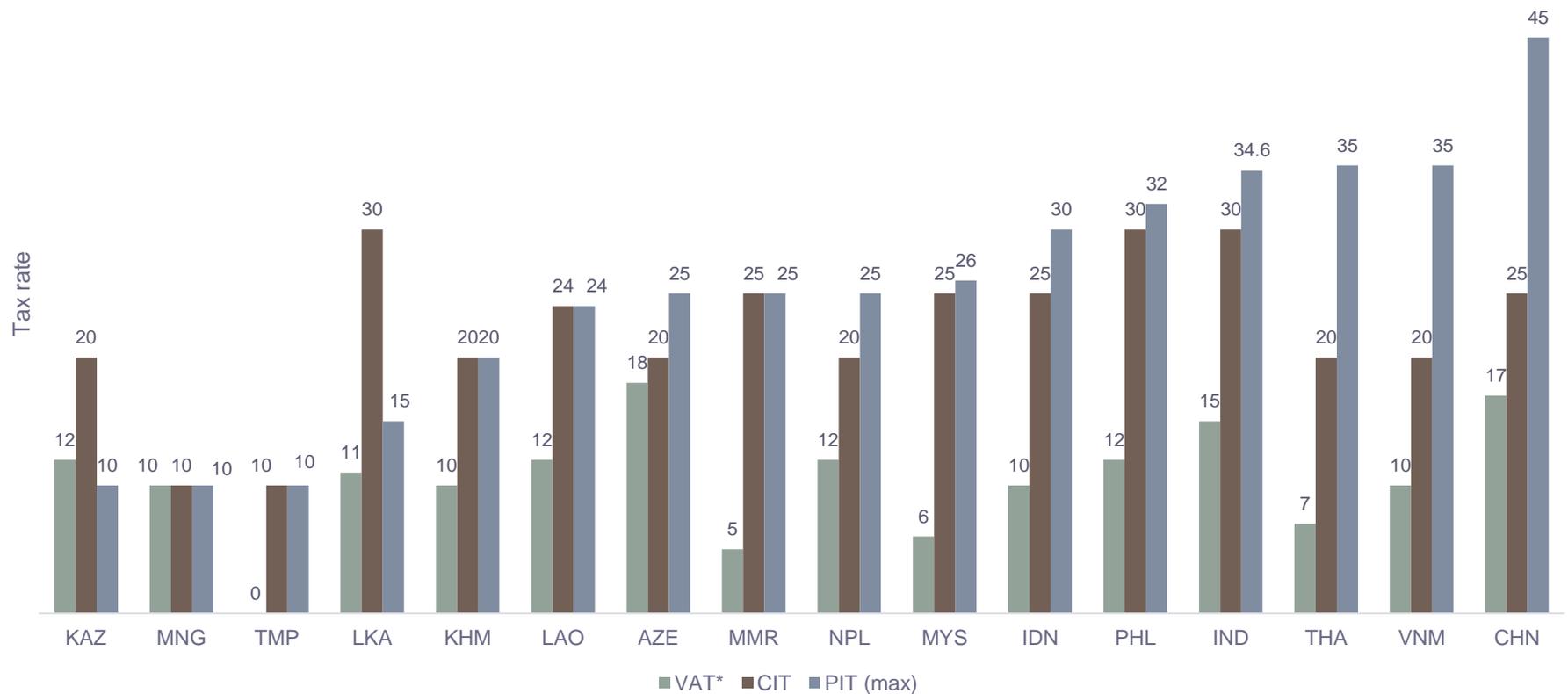
| Country     | Size of the shadow economy | Forgone VAT | Forgone CIT | Forgone PIT | Total forgone tax |
|-------------|----------------------------|-------------|-------------|-------------|-------------------|
| Azerbaijan  | 52.0                       | 4.9         | 4.5         | 1.7         | 11.1              |
| Cambodia    | 46.0                       | 3.5         | 1.5         | 0.5         | 5.4               |
| China       | 11.9                       | 0.8         | 0.5         | 0.2         | 1.4               |
| India       | 20.7                       | 0.8         | 1.0         | 0.5         | 2.3               |
| Indonesia   | 17.9                       | 0.8         | 1.0         | 0.2         | 2.0               |
| Kazakhstan  | 38.4                       | 1.9         | 5.0         | 1.4         | 8.3               |
| Lao PDR     | 28.0                       | 1.3         | 0.3         | 0.6         | 2.2               |
| Malaysia    | 29.6                       |             | 3.8         | 1.0         | 4.8               |
| Mongolia    | 16.4                       | 1.5         | 0.6         |             | 2.1               |
| Myanmar     | 47.8                       |             | 1.8         | 2.3         | 4.2               |
| Nepal       | 36.0                       | 1.2         | 0.5         | 2.8         | 4.5               |
| Philippines | 38.3                       | 1.4         | 2.2         | 1.3         | 4.8               |
| Sri Lanka   | 42.2                       | 2.2         | 0.9         | 0.2         | 3.3               |
| Thailand    | 48.2                       | 4.2         | 5.4         | 1.5         | 11.1              |
| Timor-Leste | 34.1                       |             |             |             |                   |
| Vietnam     | 14.4                       | 0.7         | 0.6         | 0.1         | 1.4               |

# Options

- Tax effort, reducing evasion
  - What to do?
  - Carrot or stick?
  - Recent experimental evidence in formalizing firms and workers
- Sri Lanka experiment (Mel et al., 2013).
  - No penalizing enforcement.
  - → Information on how to formalize.
  - → Information + monetary incentive.
  - FINDING: registration and tax formality increased by 48% by giving information + Rs\$40,000

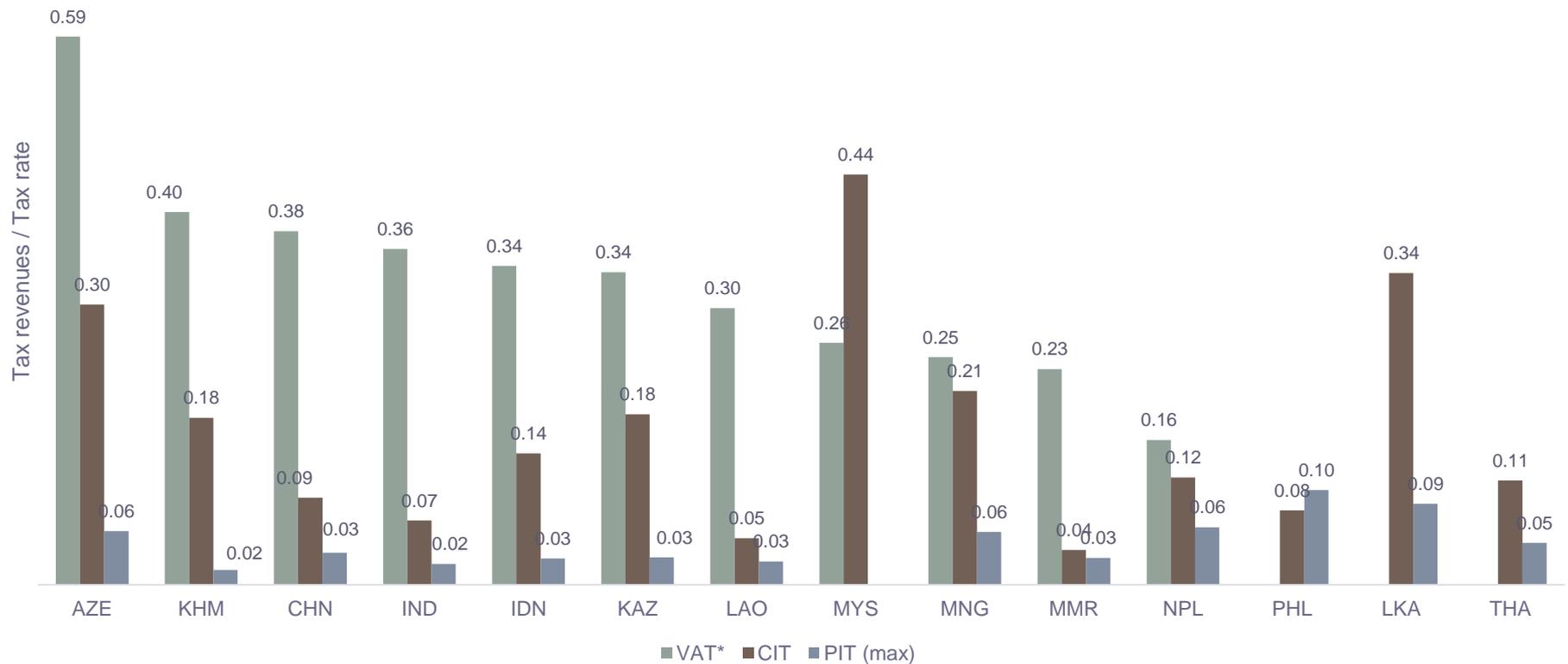
# Options

- Raising taxes
  - Current tax rates



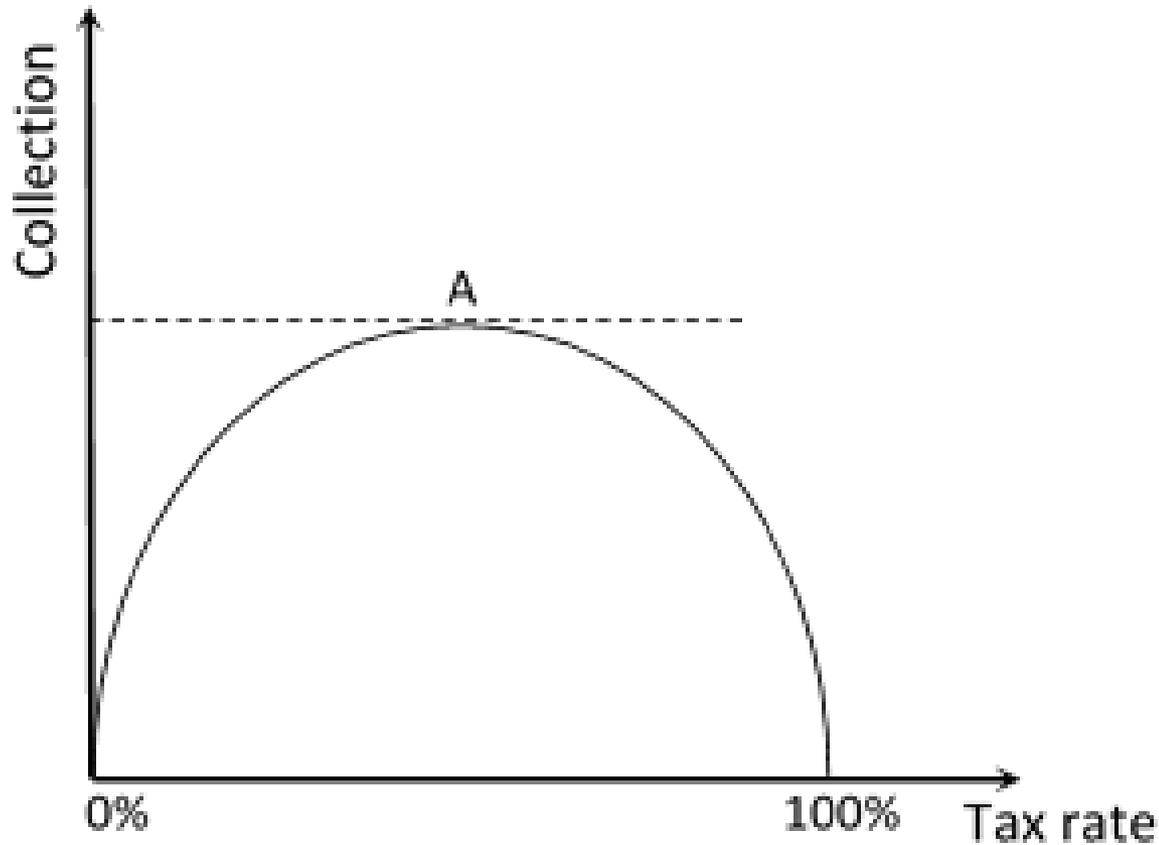
# Options

- Raising taxes
  - Tax rate productivity



# Options

- Raising taxes
  - There is a limit, what is known as the Laffer curve



# Options

- Raising taxes
  - Proposed maximum tax rates

| Country     | VAT     |         |   | CIT     |         |   | PIT     |         |   |
|-------------|---------|---------|---|---------|---------|---|---------|---------|---|
|             | Current | Maximum |   | Current | Maximum |   | Current | Maximum |   |
| Azerbaijan  | 18      | 18      | = | 20      | 20      | = | 25      | 25      | = |
| Cambodia    | 10      | 15      | + | 20      | 27.5    | + | 20      | 30      | + |
| China       | 17      | 17      | = | 25      | 25      | = | 45      | 45      | = |
| India       | 15      | 15      | = | 30      | 30      | = | 34.6    | 34.6    | = |
| Indonesia   | 10      | 17      | + | 25      | 25      | = | 30      | 30      | = |
| Kazakhstan  | 12      | 18      | + | 20      | 20      | = | 10      | 25      | = |
| Lao PDR     | 12      | 17      | + | 24      | 24      | = | 24      | 24      | = |
| Malaysia    | 6       | 18      | + | 25      | 25      | = | 26      | 26      | = |
| Mongolia    | 10      | 17      | + | 10      | 25      | + | 10      | 20      | = |
| Myanmar     | 5       | 10      | + | 25      | 25      | = | 25      | 25      | = |
| Nepal       | 12      | 12      | + | 20      | 20      | = | 25      | 25      | = |
| Philippines | 12      | 17      | + | 30      | 30      | = | 32      | 22      | = |
| Sri Lanka   | 11      | 16      | + | 30      | 30      | = | 15      | 20      | + |
| Thailand    | 7       | 17      | + | 20      | 20      | = | 35      | 35      | = |
| Timor-Leste | 0       | 12      | + | 10      | 20      | + | 10      | 25      | + |
| Vietnam     | 10      | 15      | + | 20      | 20      | = | 35      | 35      | = |

# Bottom line

- Current conditions like macroeconomic context, prices and institutional capacity are kept constant.
- Natural resources are considered to contribute with at least 1 percent of the GDP for each 5 percent of the GDP of natural resources rents.
- Energy subsidies are considered to contribute with total pre-tax subsidies and 50 percent of post-tax subsidies.
- Countries can make tax efforts to collect at least 50 percent of forgone taxes from what has been calculated in the shadow economy.
- Taxes are fully raised to the maximum proposed level.

# Bottom line

| Country     | SP-SDGs deficit (% of GDP) |                | New tax revenues to cover social protection financing gap (% of the GDP) |                            |                             |            |            |            |             |             |             |       |
|-------------|----------------------------|----------------|--|----------------------------|-----------------------------|------------|------------|------------|-------------|-------------|-------------|-------|
|             | Lower estimate             | Upper estimate | Natural resources  | Energy subsidies (pre-tax) | Energy subsidies (post-tax) | VAT effort | CIT effort | PIT effort | Raising VAT | Raising CIT | Raising PIT | TOTAL |
| Azerbaijan  | 2.6                        | 8.77           | 5.0  | 3.8                        |                             |            |            |            |             |             |             | 8.8   |
| Cambodia    | 4.0                        | 14.1           | 1.0  | 0.0                        | 0.3                         | 1.8        | 0.7        | 0.2        | 2.1         | 0.6         | 0.3         | 7.0   |
| China       | 0.2                        | 1.7            | 1.0  | 0.1                        | 0.6                         |            |            |            |             |             |             | 1.7   |
| India       | 6.6                        | 11.3           | 1.0  | 1.7                        | 4.9                         | 0.4        | 0.5        | 0.2        |             |             |             | 8.7   |
| Indonesia   | 3.7                        | 7.0            | 1.0  | 5.3                        |                             | 0.4        | 0.3        |            |             |             |             | 7.0   |
| Kazakhstan  | 1.0                        | 3.9            | 3.9  |                            |                             |            |            |            |             |             |             | 3.9   |
| Lao PDR     | 6.5                        | 10.3           | 3.0  |                            |                             | 1.3        | 0.3        | 0.6        | 1.3         |             |             | 6.5   |
| Malaysia    | 0.1                        | 6.0            | 1.0  |                            |                             |            | 1.9        | 0.5        |             |             |             | 3.4   |
| Mongolia    | 2.5                        | 7.7            | 4.0  |                            | 3.0                         | 0.7        |            |            |             |             |             | 7.7   |
| Myanmar     | 7.2                        | 13.6           | 2.0  | 0.0                        | 0.6                         |            | 1.8        | 2.3        | 0.5         |             |             | 7.2   |
| Nepal       | 5.1                        | 14.7           | 1.0  |                            | 0.6                         | 1.2        | 0.2        | 2.8        |             |             |             | 5.8   |
| Philippines | 5.9                        | 9.6            |  |                            | 0.9                         | 1.4        | 2.2        | 1.3        | 0.9         |             |             | 6.6   |
| Sri Lanka   | 0.6                        | 2.9            |  | 0.5                        | 0.6                         | 1.1        | 0.4        | 0.1        |             |             |             | 2.7   |
| Thailand    | 0.6                        | 5.1            |  | 0.3                        | 2.2                         | 2.1        | 1.4        |            |             |             |             | 6.0   |
| Timor-Leste | 7.2                        | 14.7           |  |                            |                             |            |            |            |             |             |             |       |
| Vietnam     | 1.4                        | 7.4            | 1.0  | 0.7                        | 0.3                         | 0.3        | 0.3        | 0.0        |             |             |             | 2.7   |

# Final remarks

- The purpose of this chapter was to determine the extent to which a selected group of countries can mobilise resources to finance the social protection agenda of the SGDs.
- Among financing options, the suggested sources were ordered according to their impact on growth, and redistribution potential.
- The calculations in this chapter have shown that all countries can meet at least the lower estimates of the financing needs.
- Overall, it is apparent from these calculations that unless countries adopt specific strategies to increase taxation through enforcement or other means, the social protection gap will not be filled.

# Thank you!

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