



DG DEVCO Staff Seminar on Social Protection - from strategies to concrete approaches -

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SESSION 5

SP from the fiscal perspective

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Outline

- Framework: Key Policy Levers
- Concepts and Terms of Art
- Fiscal Incidence: quantifying the impact of fiscal policy on poverty and inequality
- SP within a fiscal incidence framework

Key Policy Levers

Which policies?

| Policy Issue | Research finding | Policy implication |
|-------------------------------|---|---|
| Tackling asset inequality | | |
| Land Reform | Land inequality an important driver of asset inequality in many low-income and lower middle-income countries with large agricultural sectors. Insecure tenure can reduce investments of the poor | Land reform with redistribution component an important policy-lever. Tenure reform should focus on improving tenure security for current users. |
| Education and health policies | Pro-poor education and health policies can reduce inequality in human capital and promote economic growth; educational inequality important driver of overall inequality | Focus public health and education expenditures on basic education and health care, enable the poor to access higher education and health (through loans, and insurance schemes, respectively) |
| Credit policies | Lack of access to capital a significant constraint for the poor to invest; capital markets do not work for them and many microcredit schemes bypass the poorest and/or lead to high indebtedness; | Support microcredit institutions that reach the poorest and provide sustainable credit (usually with subsidy element) |
| Gender policy | Gender inequality exacerbates income inequality via educational inequalities, health inequalities, inequalities in access to financial services, etc. which in turn reduces growth and pro-poor growth. | Thus, promoting female education, employment and access to health care (also to constrain fertility) will decrease gender inequality and thus promote more equality in income. |

Which policies?

| | | |
|---|---|--|
| Improving returns to asset for the poor | | |
| Infrastructure | Rural infrastructure can improve the functioning of agricultural input and output markets | Promote the construction of rural roads and associated market infrastructure |
| Agricultural policies | Inequality heavily affected by low agricultural productivity of poor producers, related to low access and use of modern inputs and seeds, lack of infrastructure, extension services, etc. | Prioritize access to seeds and modern inputs for poor farmers through subsidy schemes, starter-packs, targeted extension services, etc. |
| Labor market policy | Unequal distribution of employment and earnings key driver of inequality, particularly in middle-income countries; active labor market policies including minimum wages and training initiatives can reduce labor market inequality there | Invest in education and training of the poor; improve access to labor markets through dedicated services for them; provide incentives for formalization; consider minimum wages (in middle-income countries); |

Which policies?

| Increasing redistribution by the state | | |
|--|--|---|
| Fiscal policy | Fiscal policies are especially important for (i) fighting inequality directly via a progressive tax regime as well as for (ii) financing social transfers and public expenditure benefiting the poor. Tax/GDP ratios generally low and increases have tended to help lower inequality, esp. in middle-income countries | Increasing the tax per GDP ratio through reducing exemptions, closing tax loopholes and tax evasion, and some increases in progressive taxation (e.g. luxury VAT, commodity taxation); re-orient public spending towards the poor by increasing access to government services, asking for co-payments among non-poor, and introducing new pro-poor programs |
| Social policy | Transfers to the poor (including conditional cash transfer programs and non-contributory social pensions and child grants) decrease poverty, lower inequality, can promote human capital investment, and risk-taking by the poor. | Promote social protection programs that are broad in coverage, easy to administer, and fiscally sustainable (costs less than 1-2%/GDP) |
| Improving public sector management | Poorly functioning public sector (government and state-owned enterprises) lowers ability to effect redistributive policies | Strengthen state capacity through improved financial management and public oversight; analyze distributional impact of public spending; harden budget constraints for state-owned enterprises. |

Which policies?

| Other policies with inequality implications | | |
|---|---|---|
| Macroeconomic and monetary policy | Low inflation and competitive exchange rates are both important for macroeconomic stability and for fighting income inequality. | Set targets for low inflation, manage exchange rate and capital inflows, ensure low fiscal deficits; |
| Trade policy | Trade liberalization is important for macroeconomic stability, economic growth and diversification, but can be inequality-enhancing. | Removing export-bias and enhancing free trade (especially regional and South-South trade) is generally desirable. Temporary protection of infant industries and prevention of re-primarization (undermining industrialization by returning to a focus on agriculture and resource extraction for exports) is advisable for poor countries. Maintain competitive exchange rate |
| Structural policy | Since many of the poor still live in rural areas and thus depend on agriculture for income, regional and sectoral policies can benefit the fight against income inequality if focused on promoting productivity of land and labor. Regional inequalities moreover slow down economic growth and enhance inequality; industrial policy focused on urban areas can increase inequality in the short-term. | Focus on improving agricultural productivity and earnings for poorest; promote labor-intensive industrialization; accommodate rural-urban migration; promote infrastructure and agriculture in backward regions. |
| Governance | Poor governance usually inequality-enhancing as the poor suffer particularly under corruption, poor state capacity and inadequate services. | Promote governance reforms that increase transparency, tackle corruption, and improve state capacity, particularly in the delivery of services. |

Which policies?

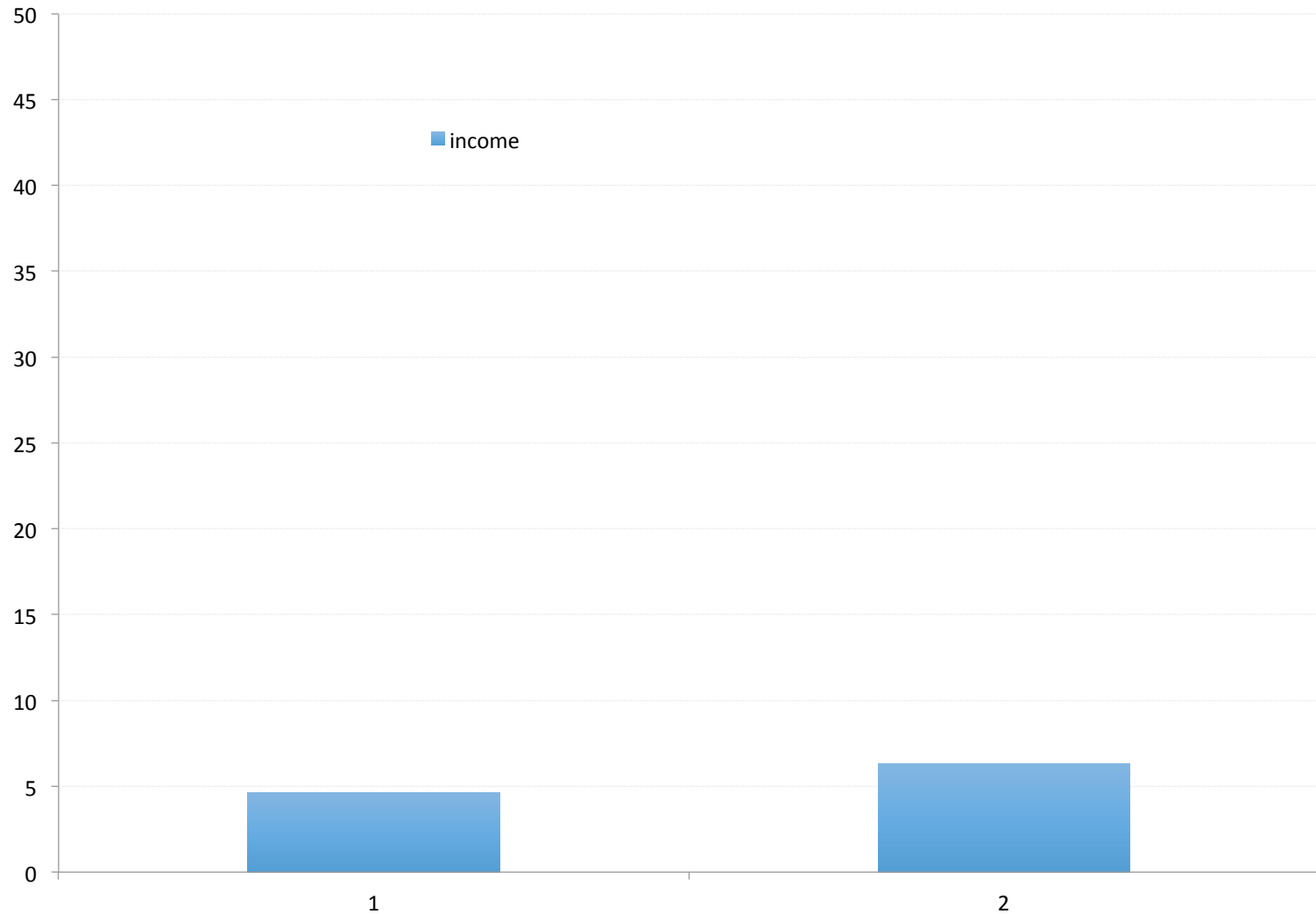
| International Trends and Policies that can Affect Within-Country Inequality | | |
|---|---|--|
| Tax transparency and compliance | Capital flight and tax evasion by wealthy individuals, and tax avoidance by multinational companies reduces tax revenues and redistribution by the state; | OECD processes to reduce tax evasion by individuals and tax avoidance by multinational companies should ensure developing countries benefit fully from new rules and systems |
| Trade Policy | Further trade liberalization in rich countries in agriculture and services can promote pro-poor exports; trade facilitation can promote pro-poor exports | Complete Doha Development Round (or alternative processes) focusing on facilitating exports from poorer segments of developing countries, focusing on agriculture, services, and trade facilitation; |
| Capital and labor flows | Capital flows can provide much-needed resources for pro-poor growth; but many capital flows, esp. short-term flows as well as most FDI will likely increase inequality; also, short-term capital inflows are destabilizing; remittances can help reduce inequality if migration of the poor is facilitated; | Regulation and management of short-term capital inflows important to prevent financial crises; transparent immigration policy can facilitate remittances and migration of poorer segments of population. |

Which policies?

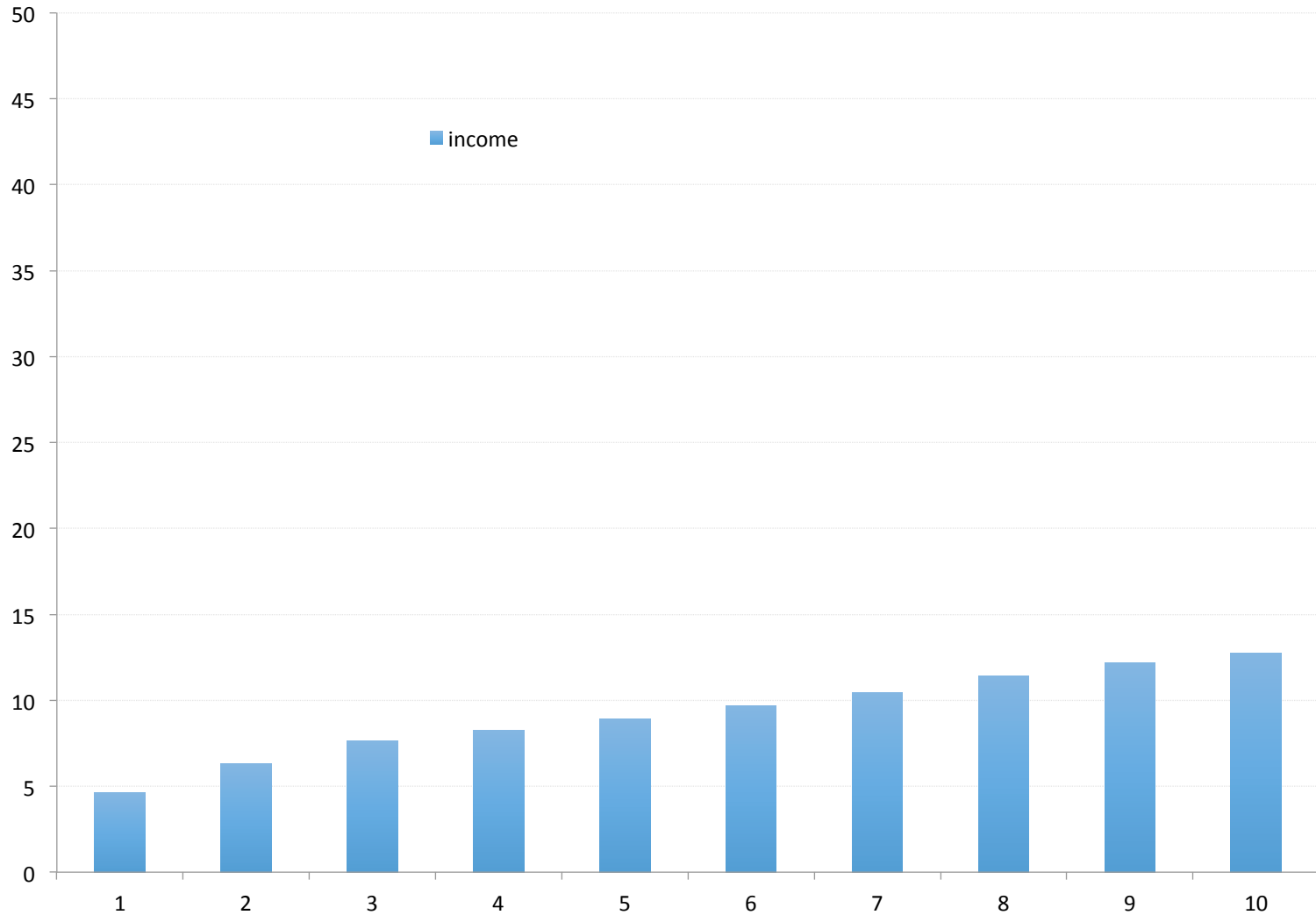
| Policy | Keywords |
|------------------|--|
| Education/Health | Focus expenditures... loans... insurance |
| Credit | ...subsidy element |
| Infrastructure | ...construction |
| Agricultural | ...subsidy schemes, starter packs, extension services |
| Fiscal/Revenue | ...increase tax-to-GDP ratio...increases in progressive taxation |
| Social | ...social protection schemes (transfers, insurances) |
| Trade | ...enhance free trade |

Terms of Art

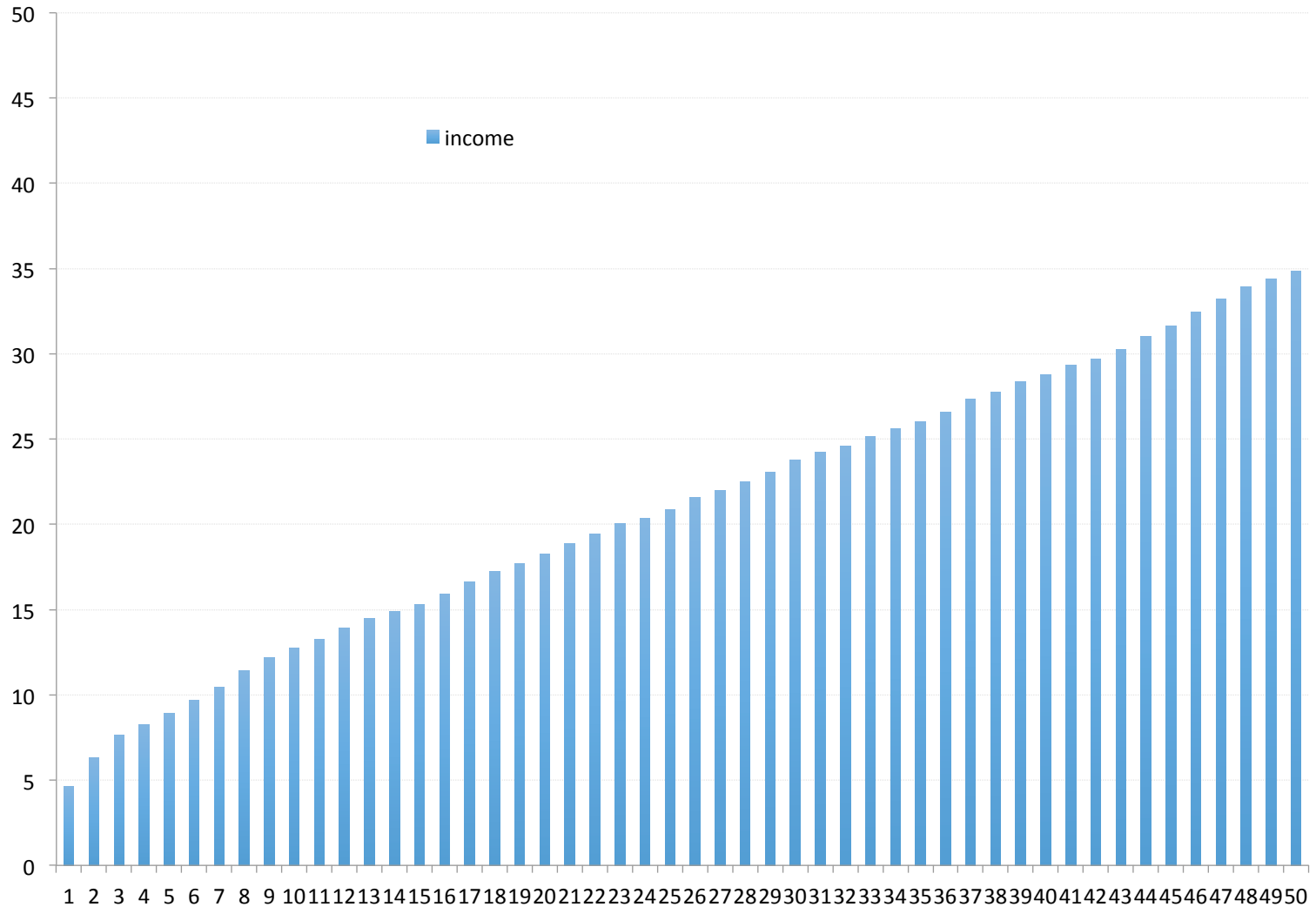
Rank individuals, poorest to richest



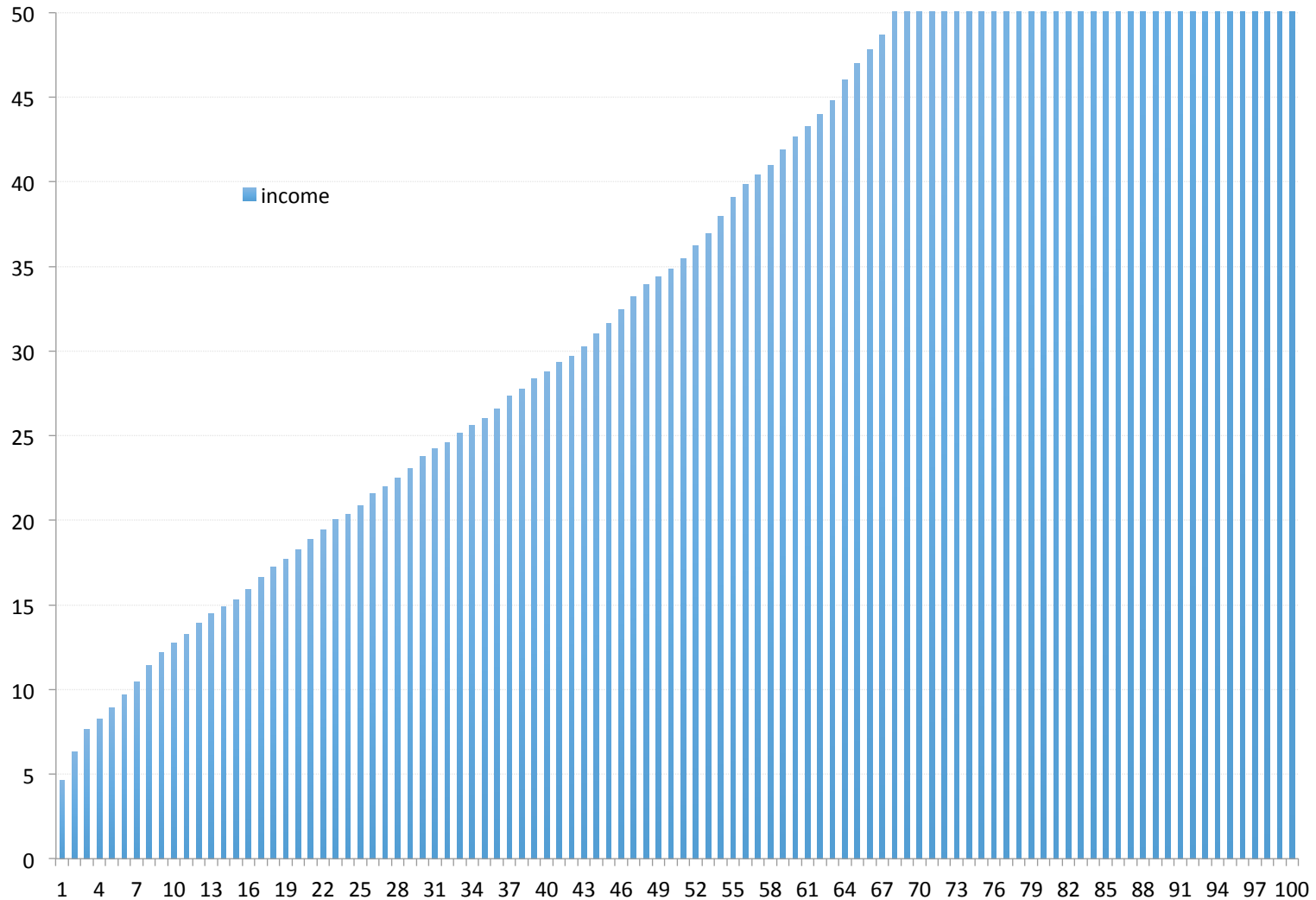
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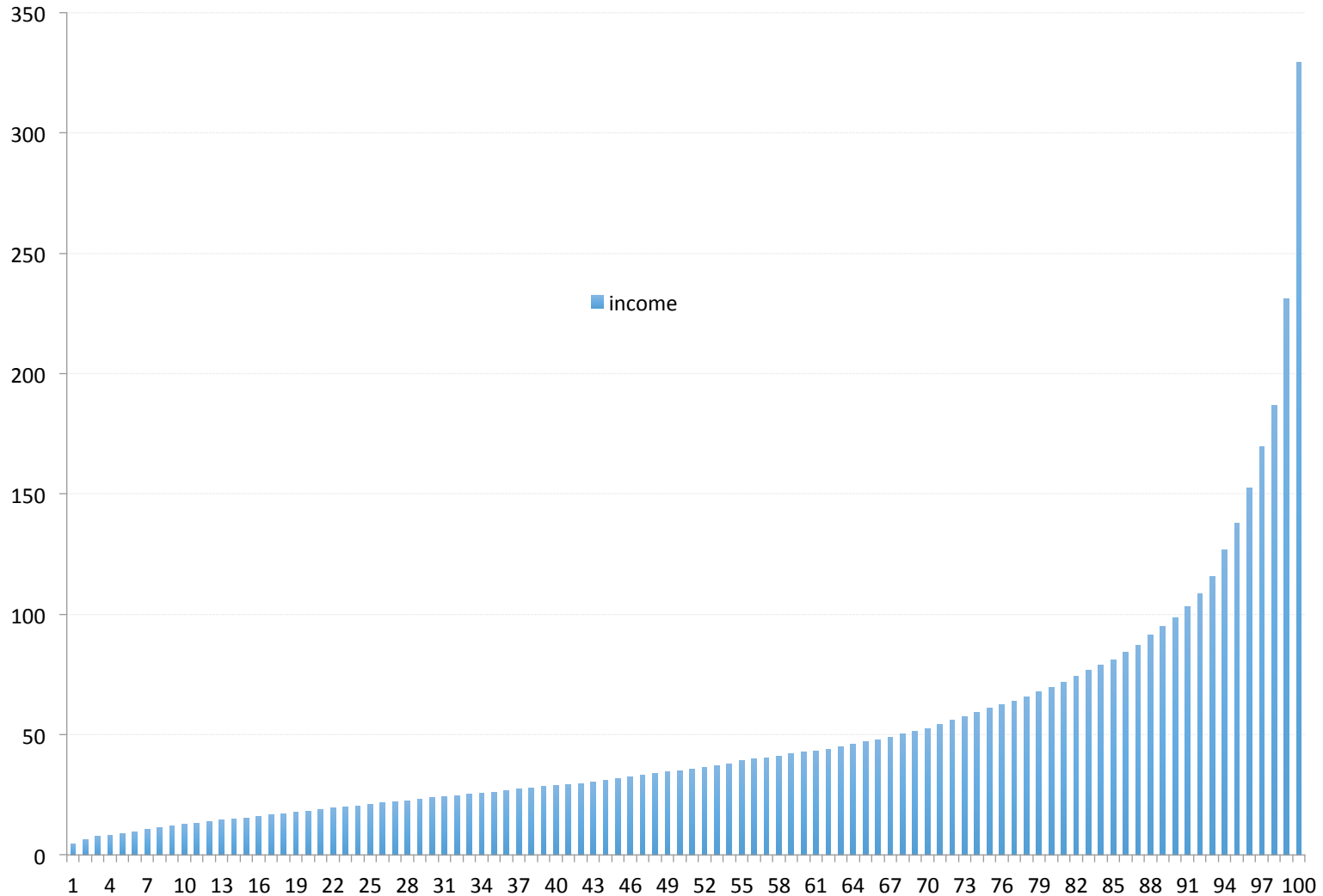
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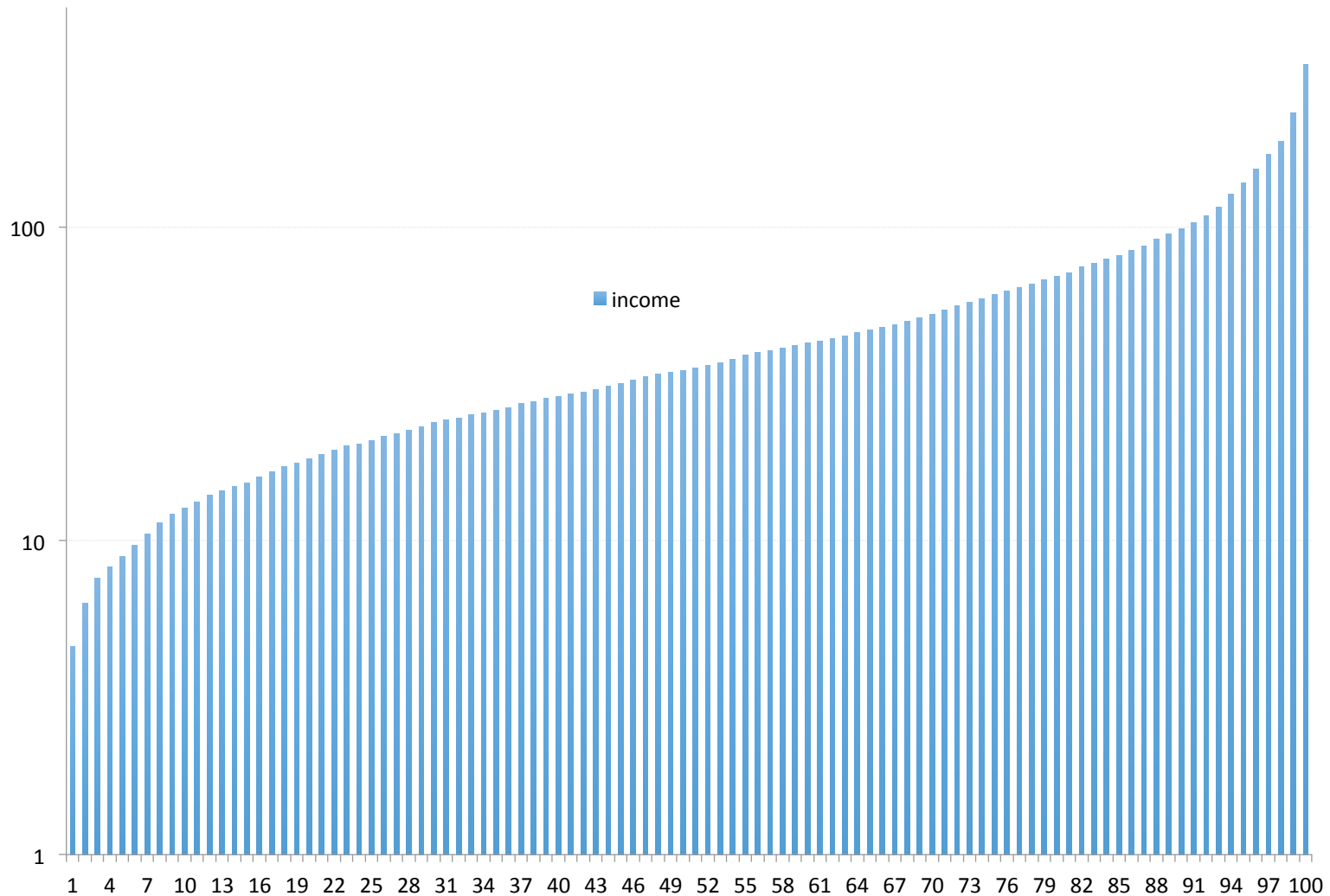
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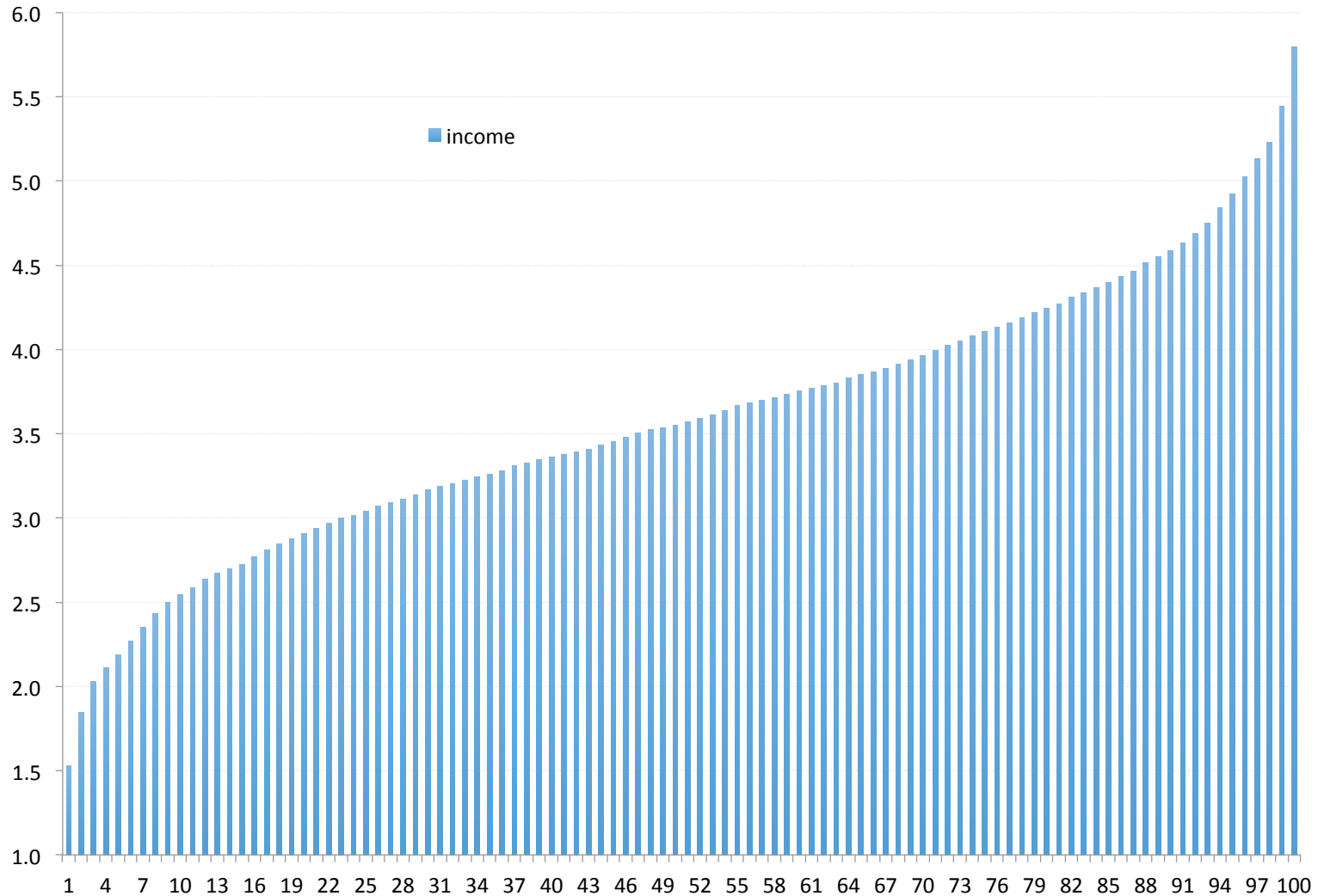
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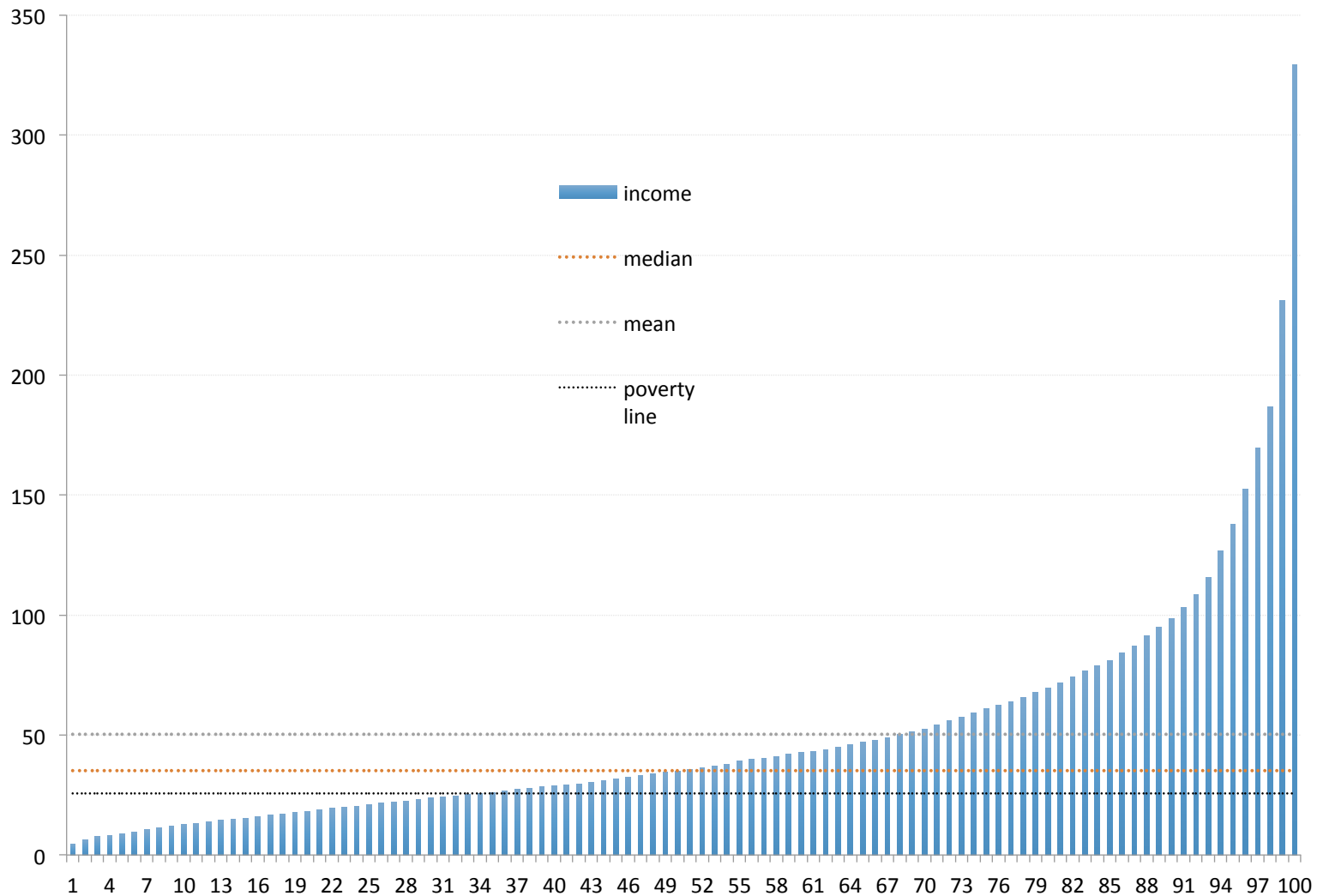
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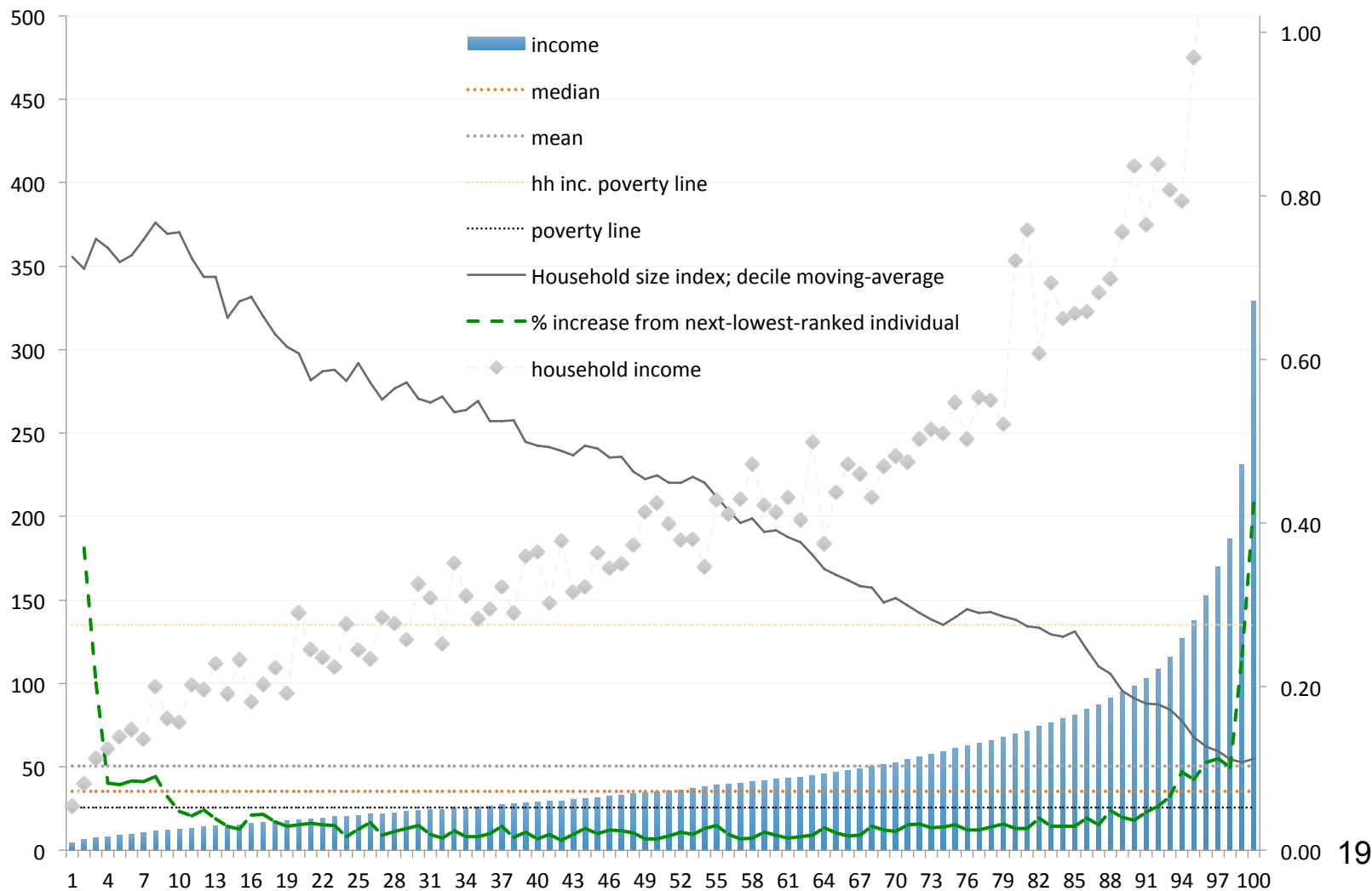
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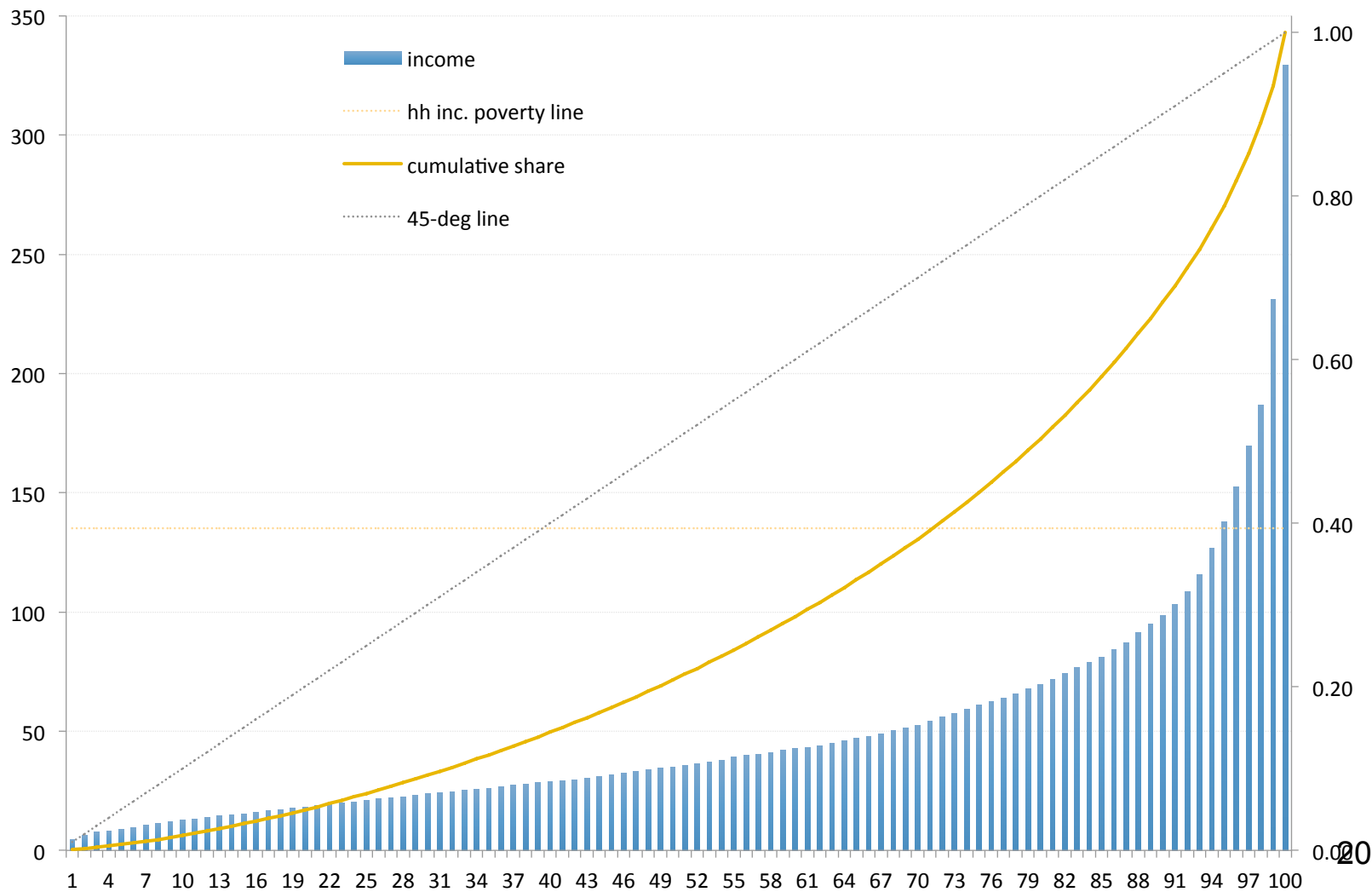
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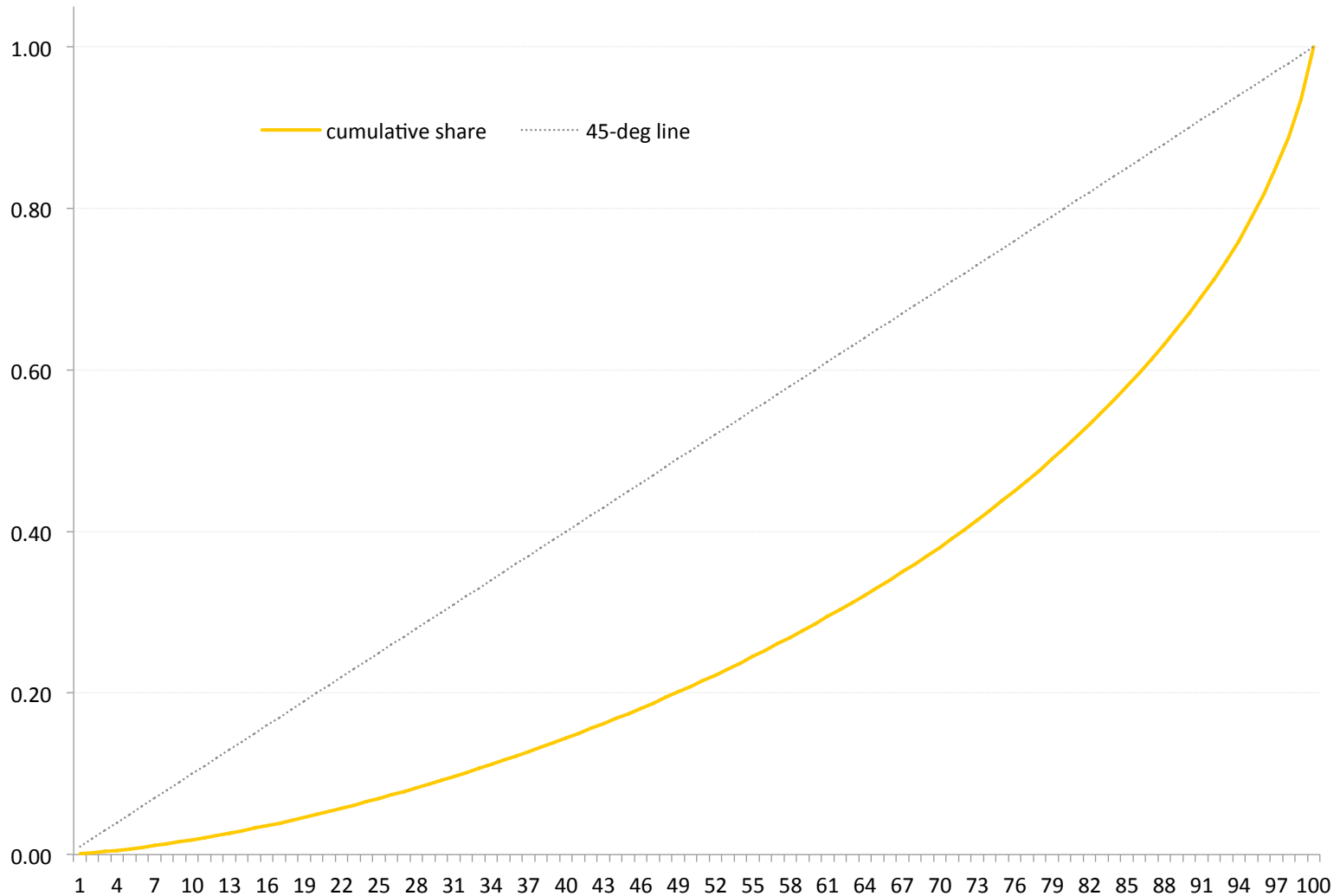
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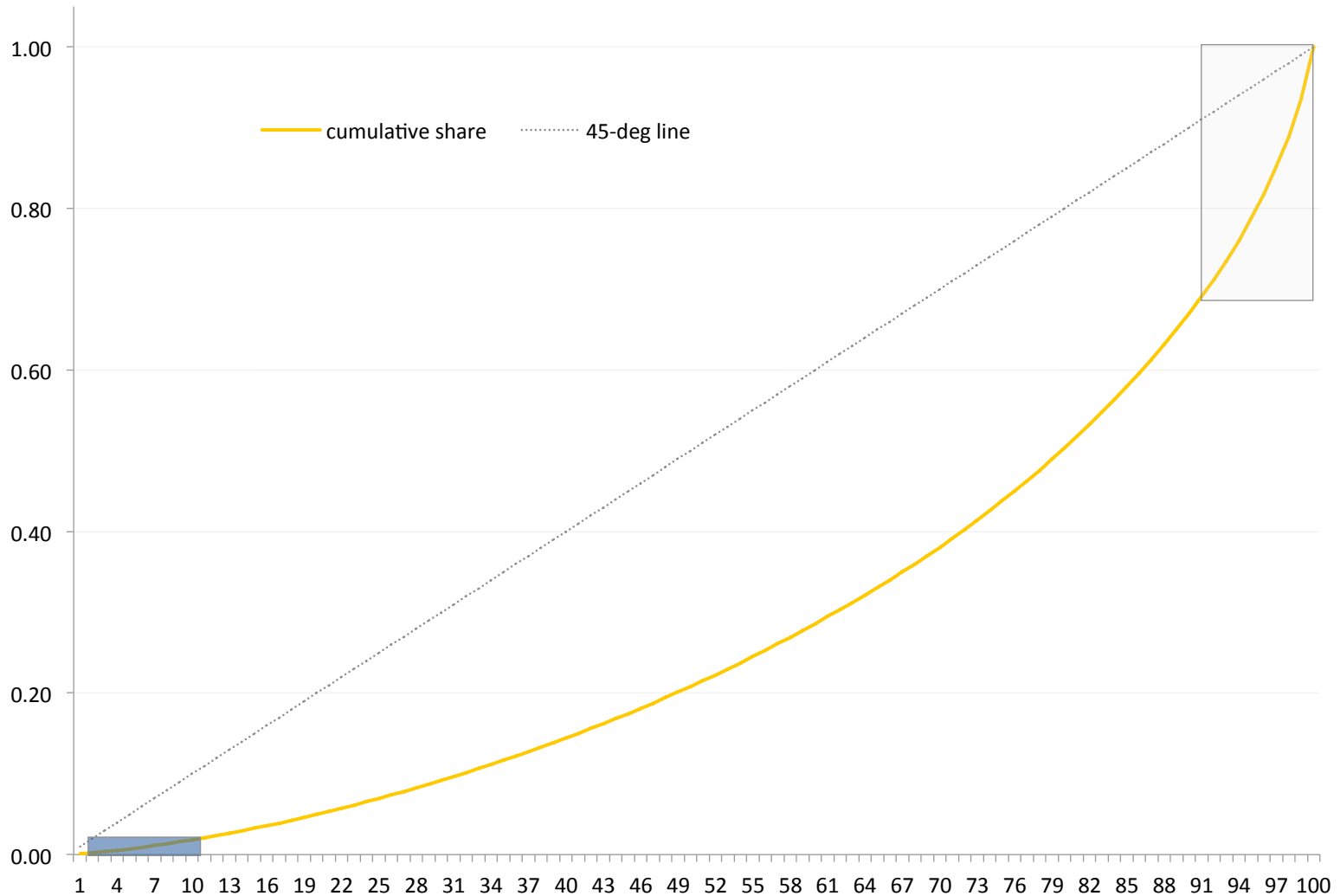
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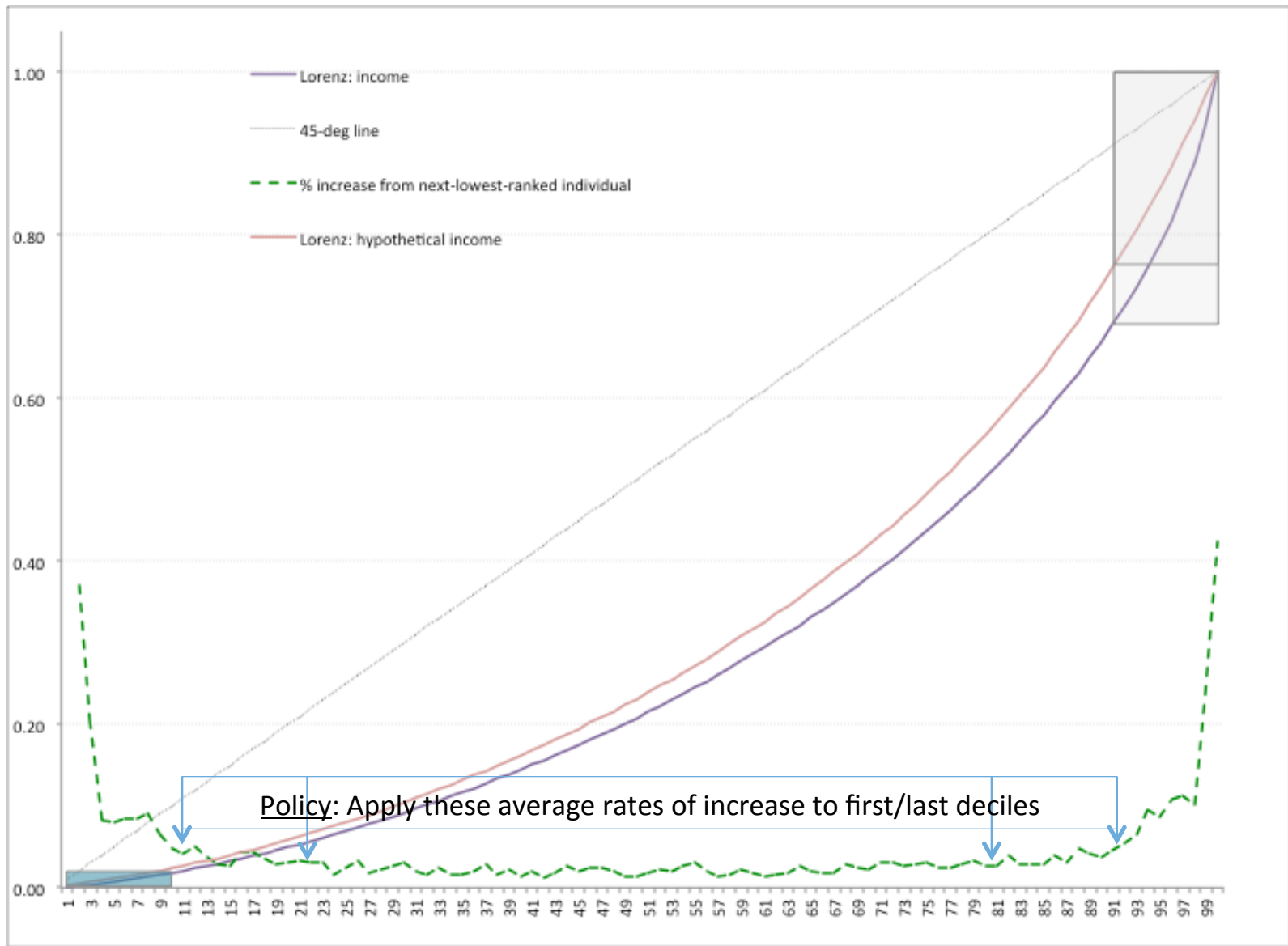
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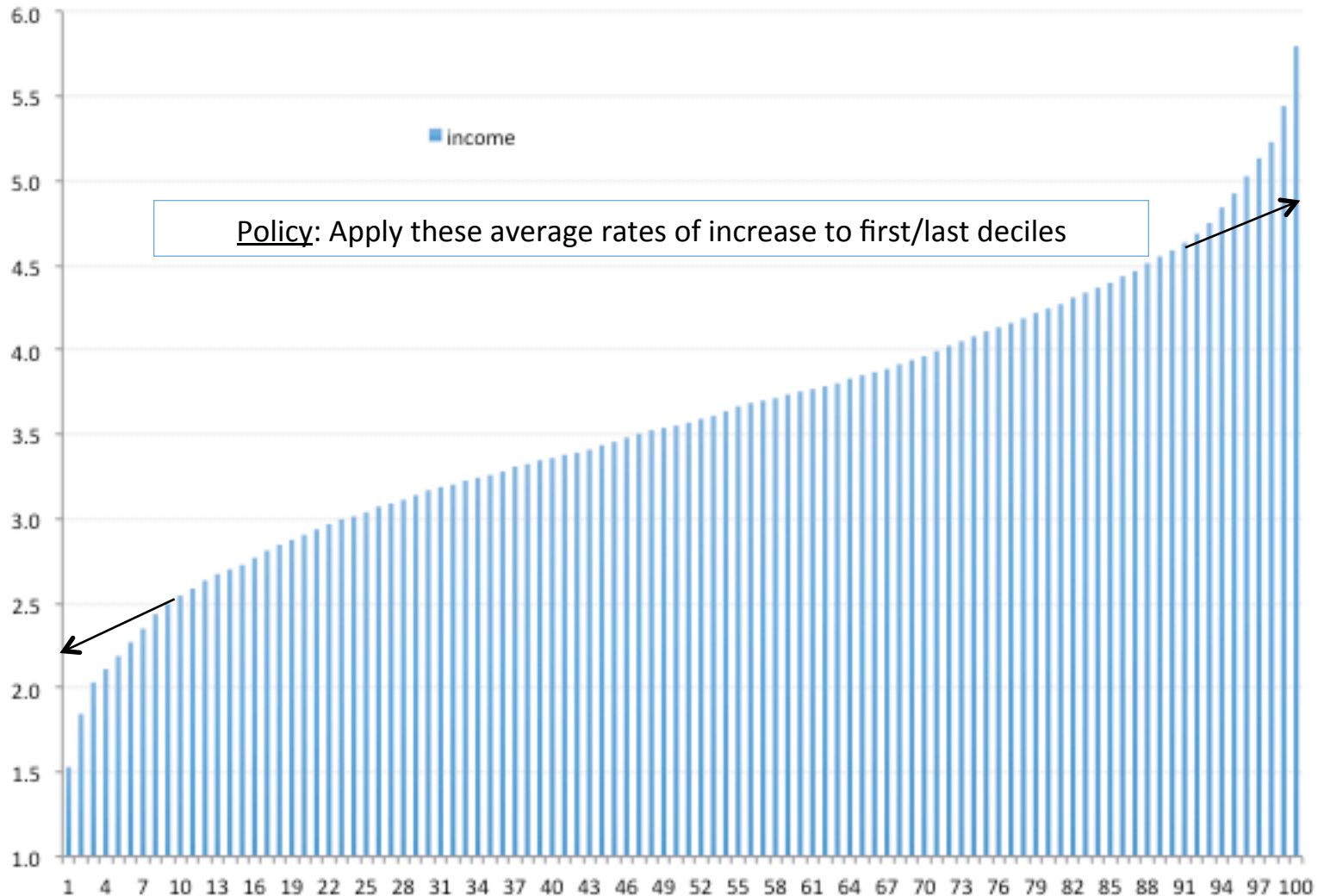
Lorenz curve: cumulative share of ranked individuals



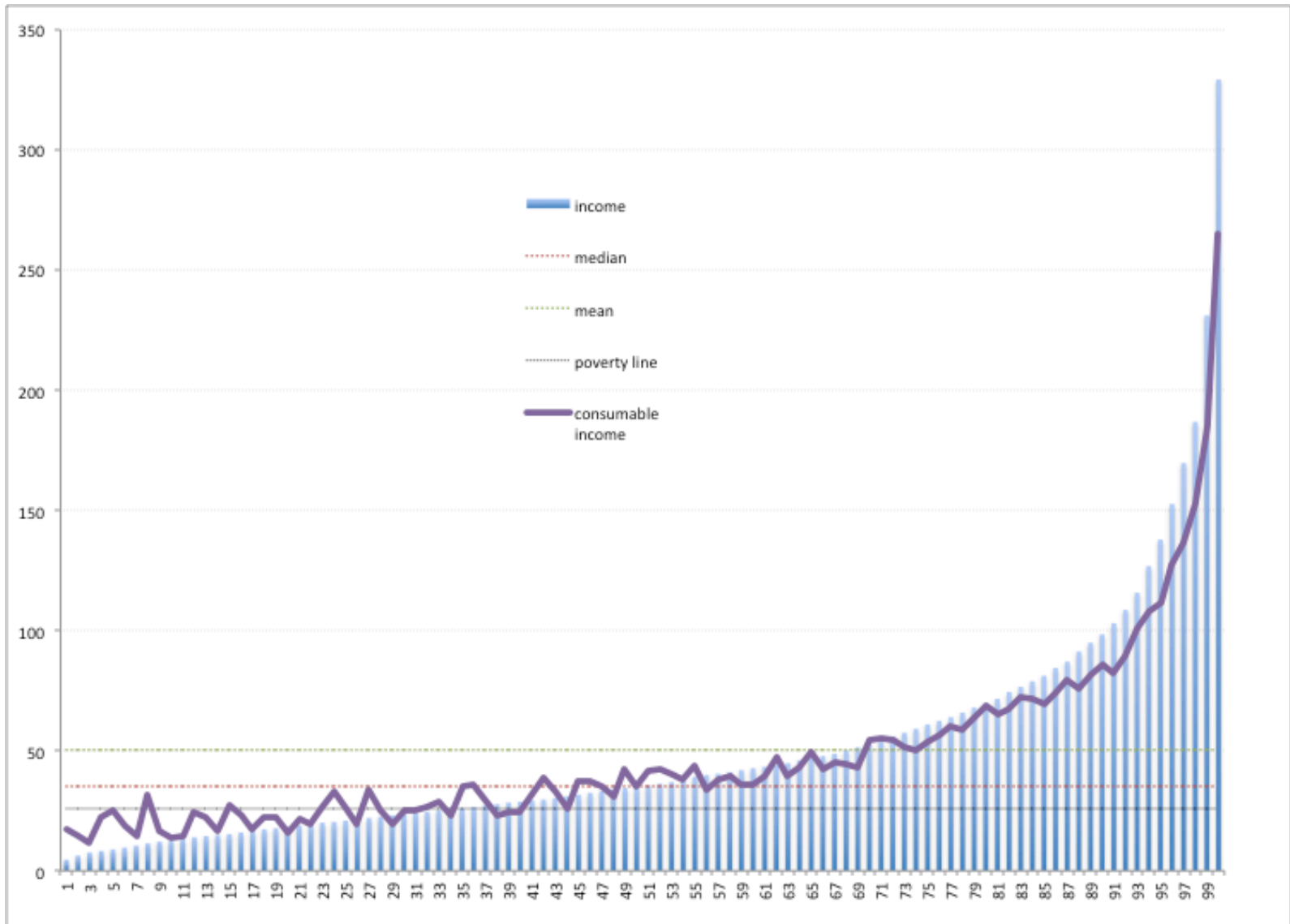
Pre-"policy" Gini: 0.4395
Post-"policy" Gini: 0.3829



Pre-"policy" Gini: 0.4395
Post-"policy" Gini: 0.3829



Fiscal Policy: direct transfer + consumption tax

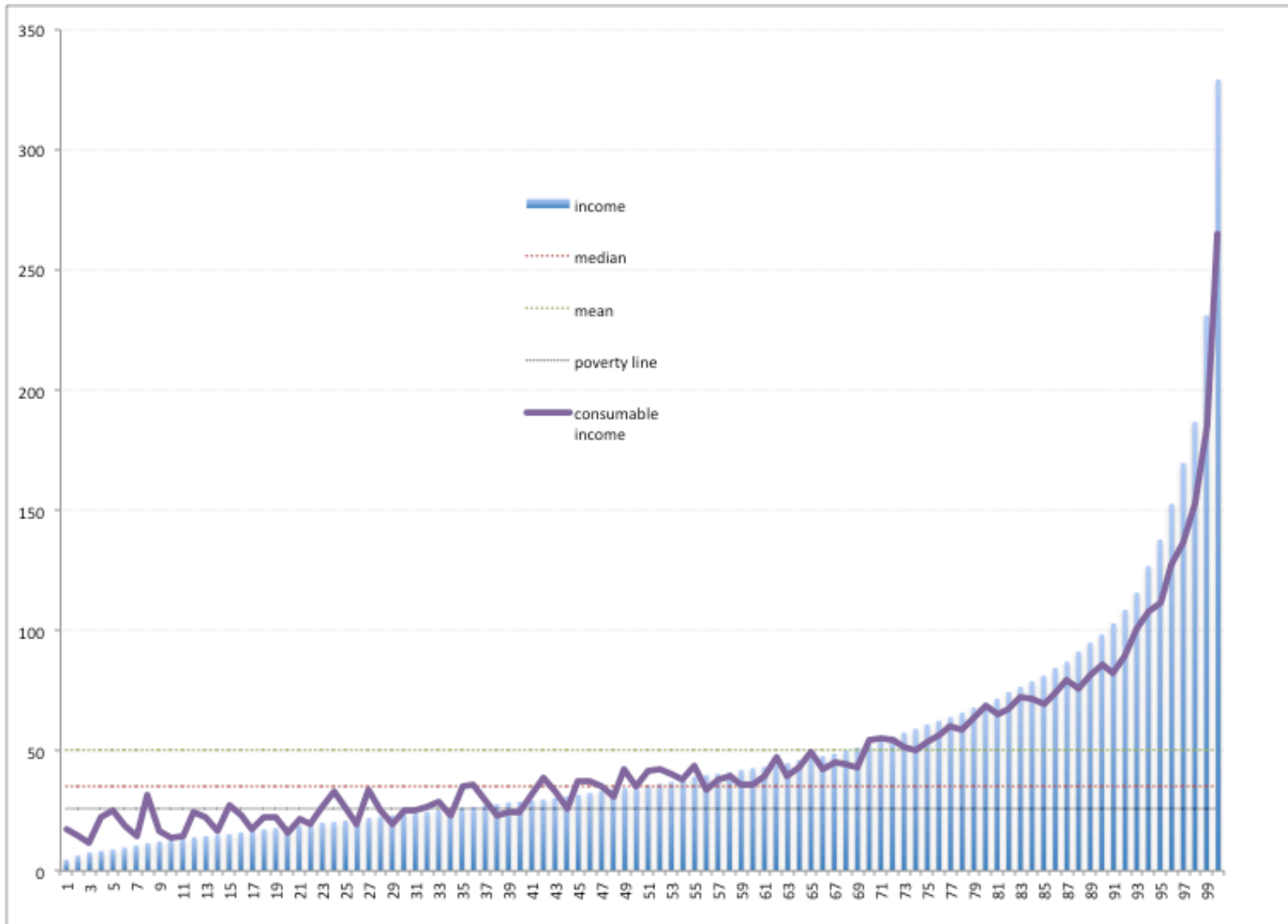


Benefits (as share of pre-policy income) decline with pre-policy income shares.

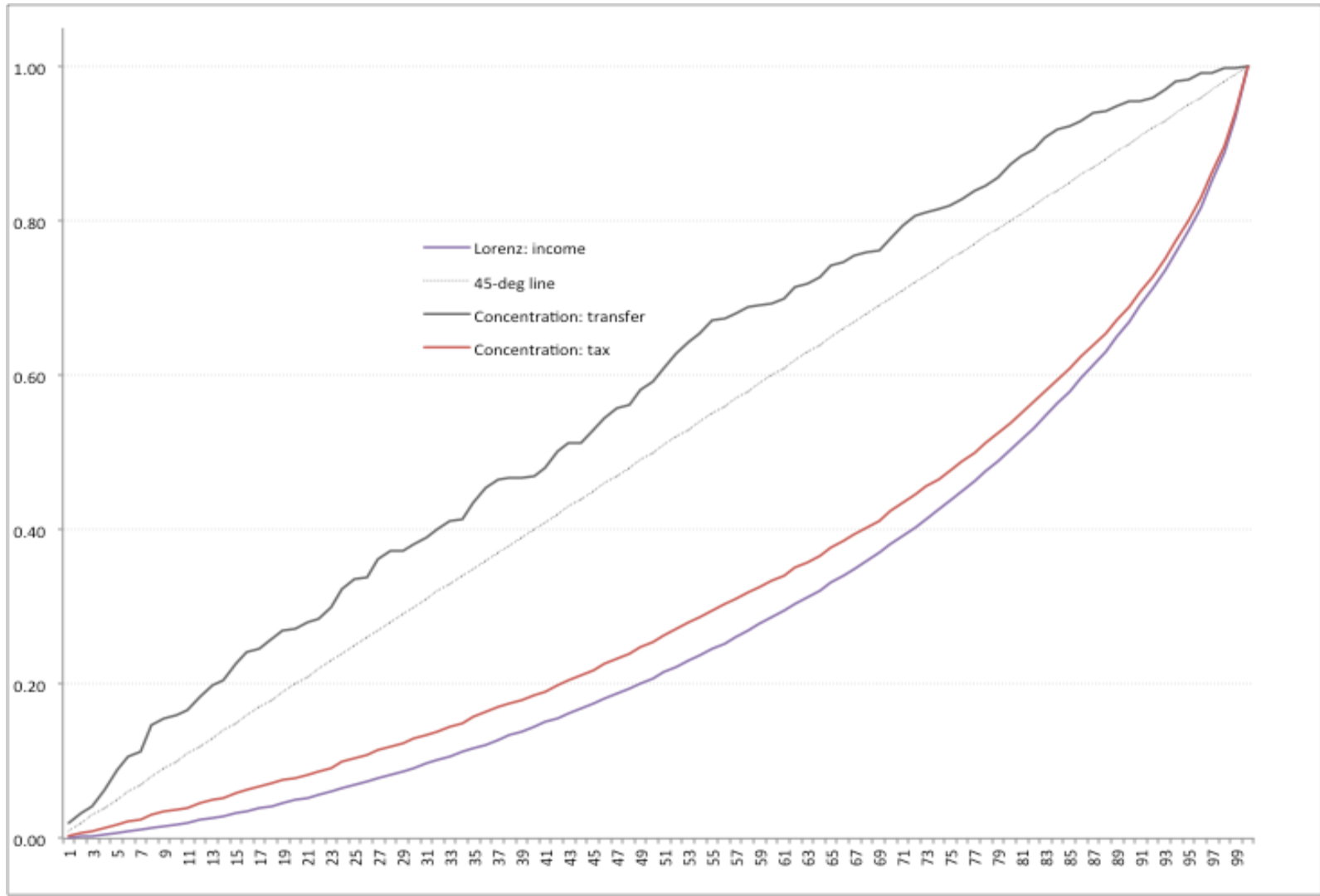
“Net payers” are in the 7th decile (or richer)



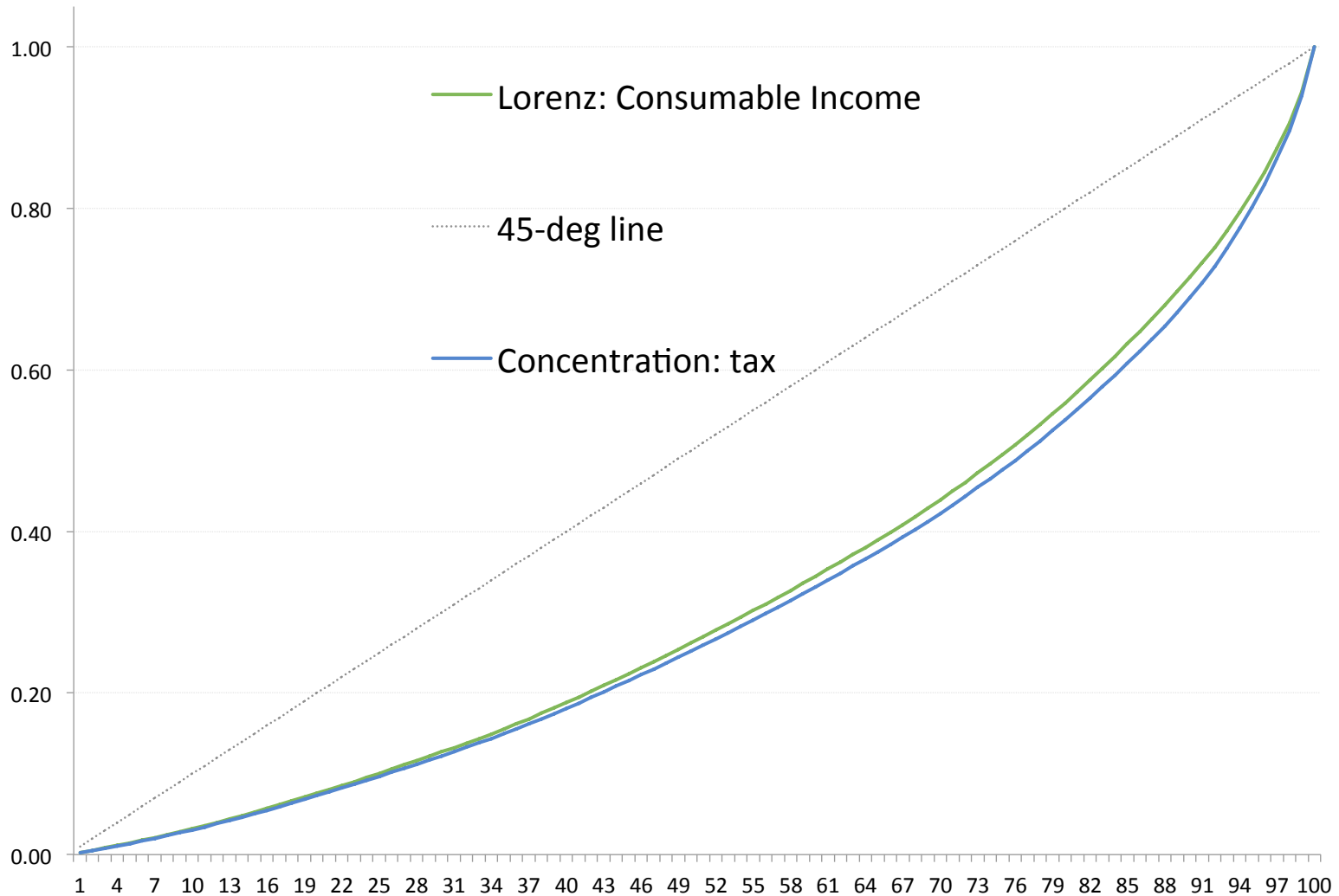
Pre-"policy" Gini, Headcount: 0.4395, 34%
Post-"policy" Gini, Headcount: 0.3829, 30%

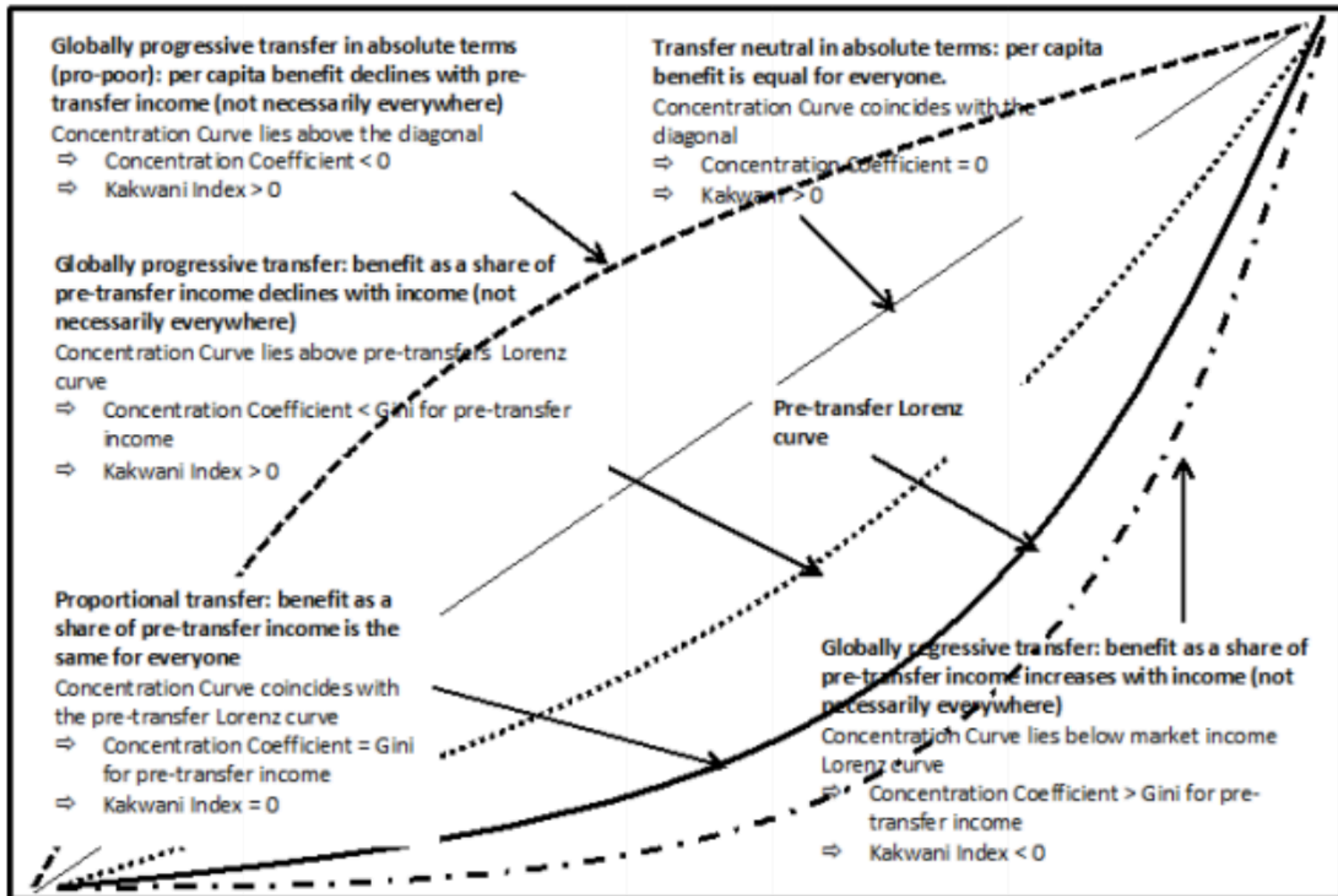


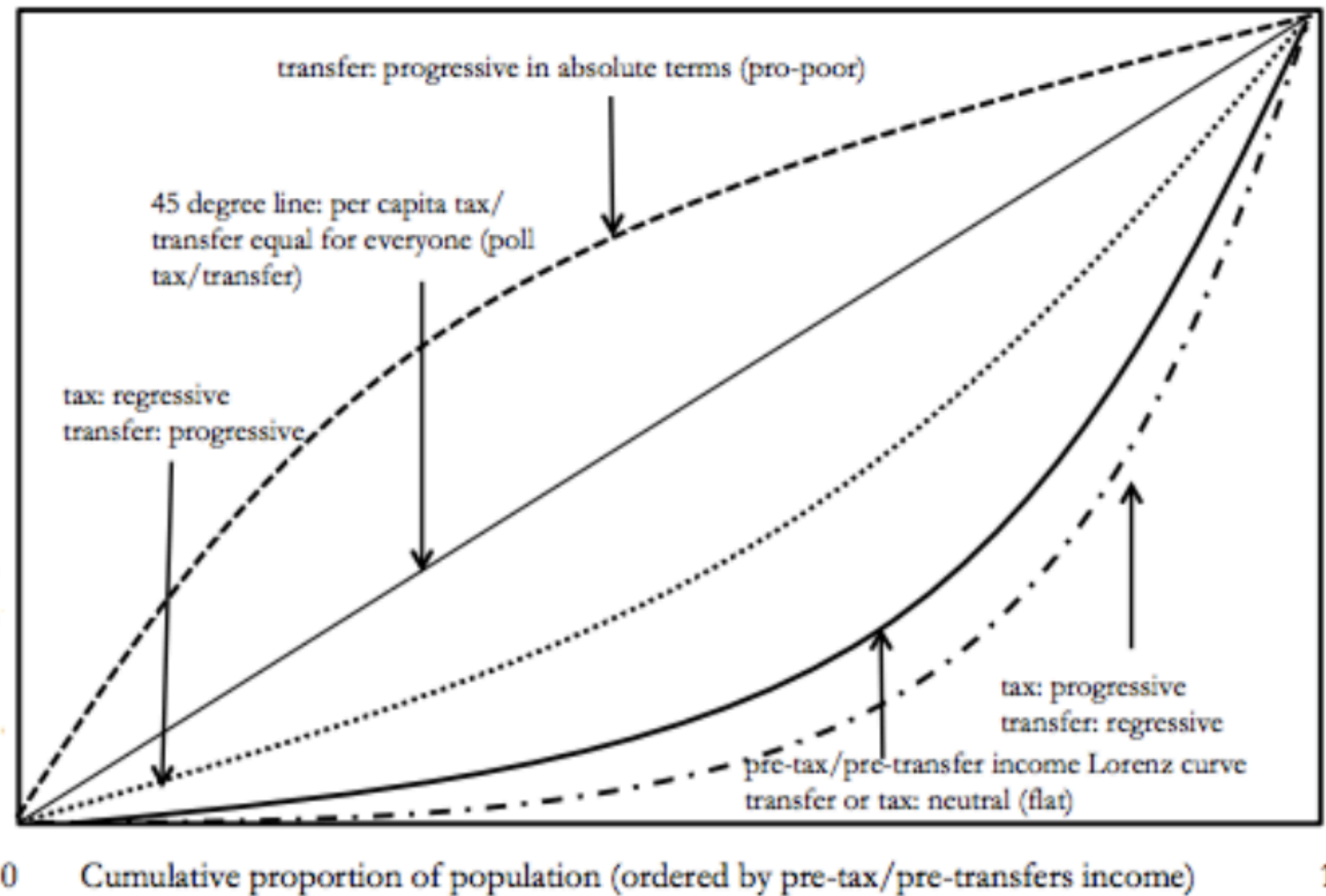
Is the transfer progressive?
Is the tax?



Is the tax progressive?



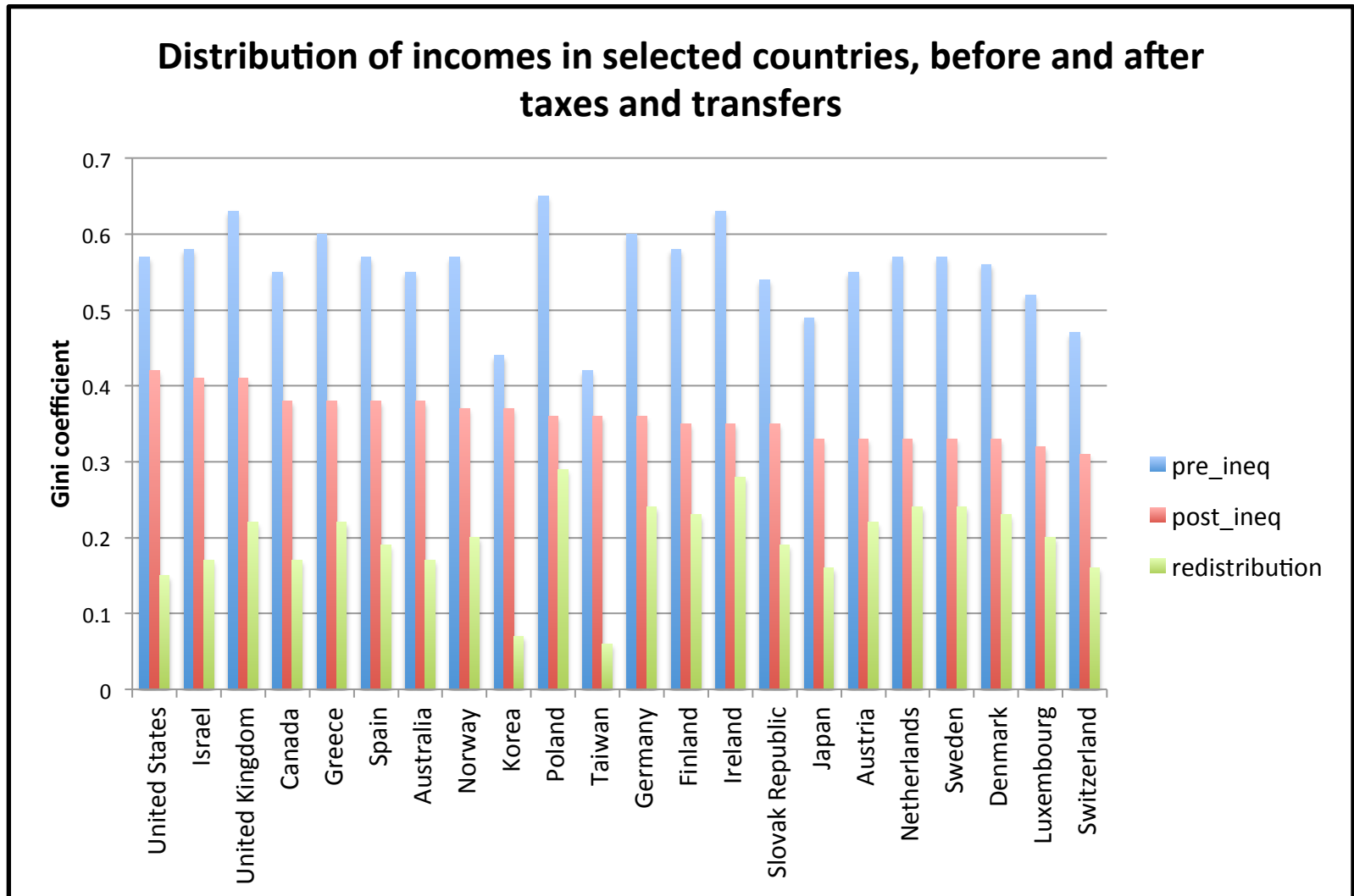




Fiscal Incidence:

Measuring the Impact of Fiscal Policy on Inequality and Poverty

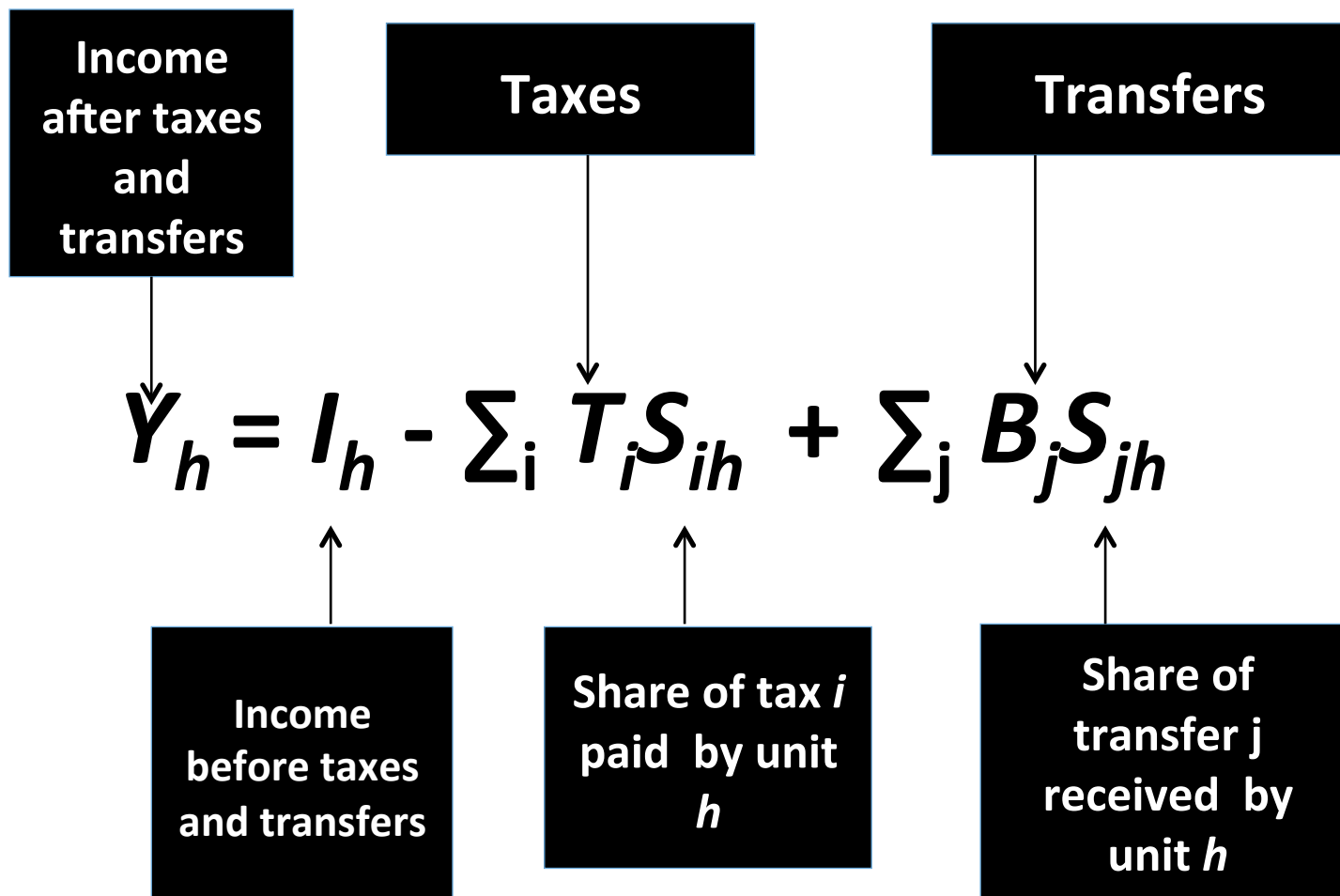
Whence the red and blue bars?



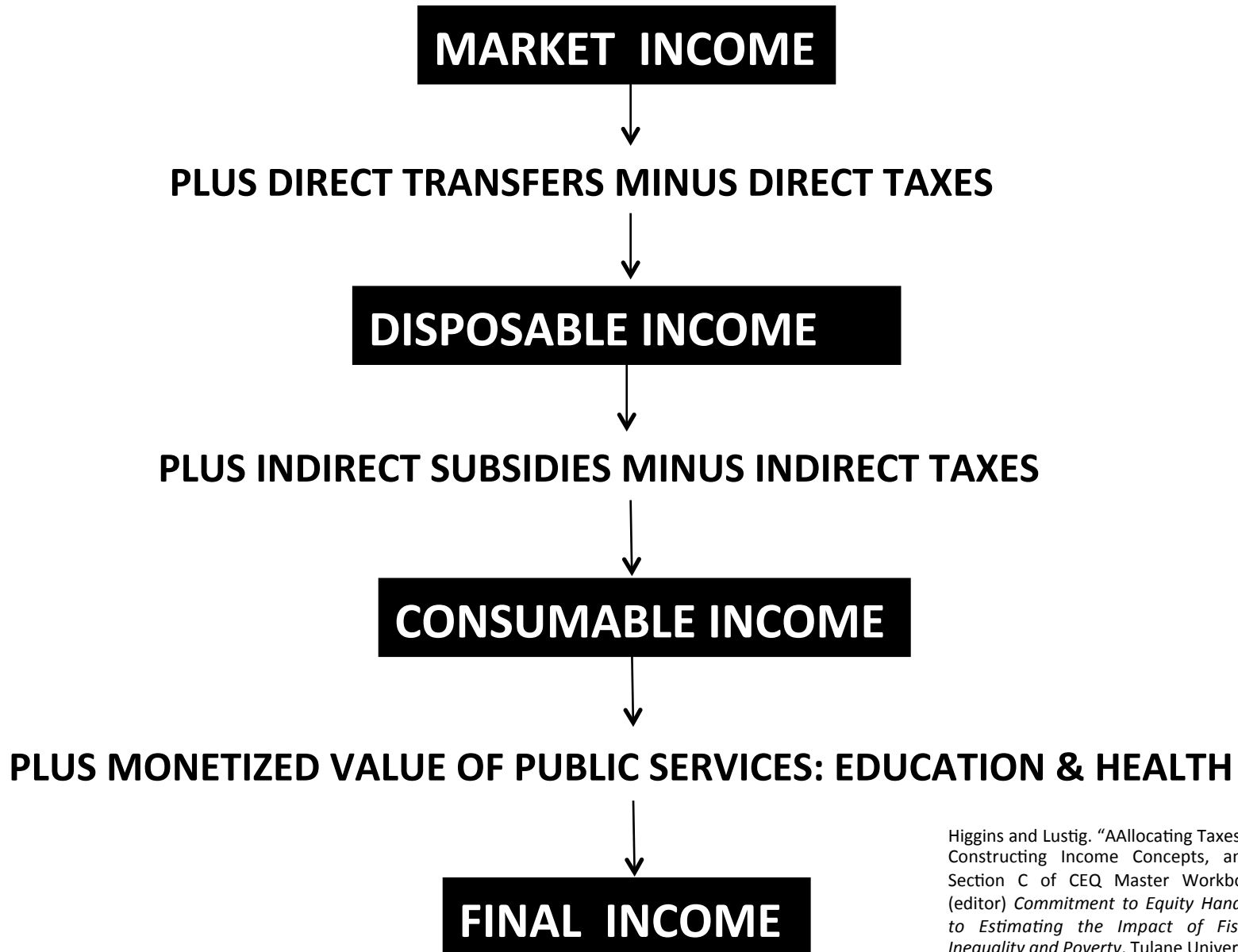
CEQ Assessment: Fiscal Interventions

- Currently included:
 - Direct taxes (mainly personal income tax and payroll taxes)
 - Direct cash transfers
 - Non-cash direct transfers such as school uniforms and breakfast
 - Contributions to pensions and social insurance systems
 - Indirect taxes on consumption
 - Indirect subsidies
 - In-kind transfers such as spending on education and health
- Working on:
 - Corporate taxes
 - Infrastructure

CEQ Assessment: Fiscal Incidence Analysis

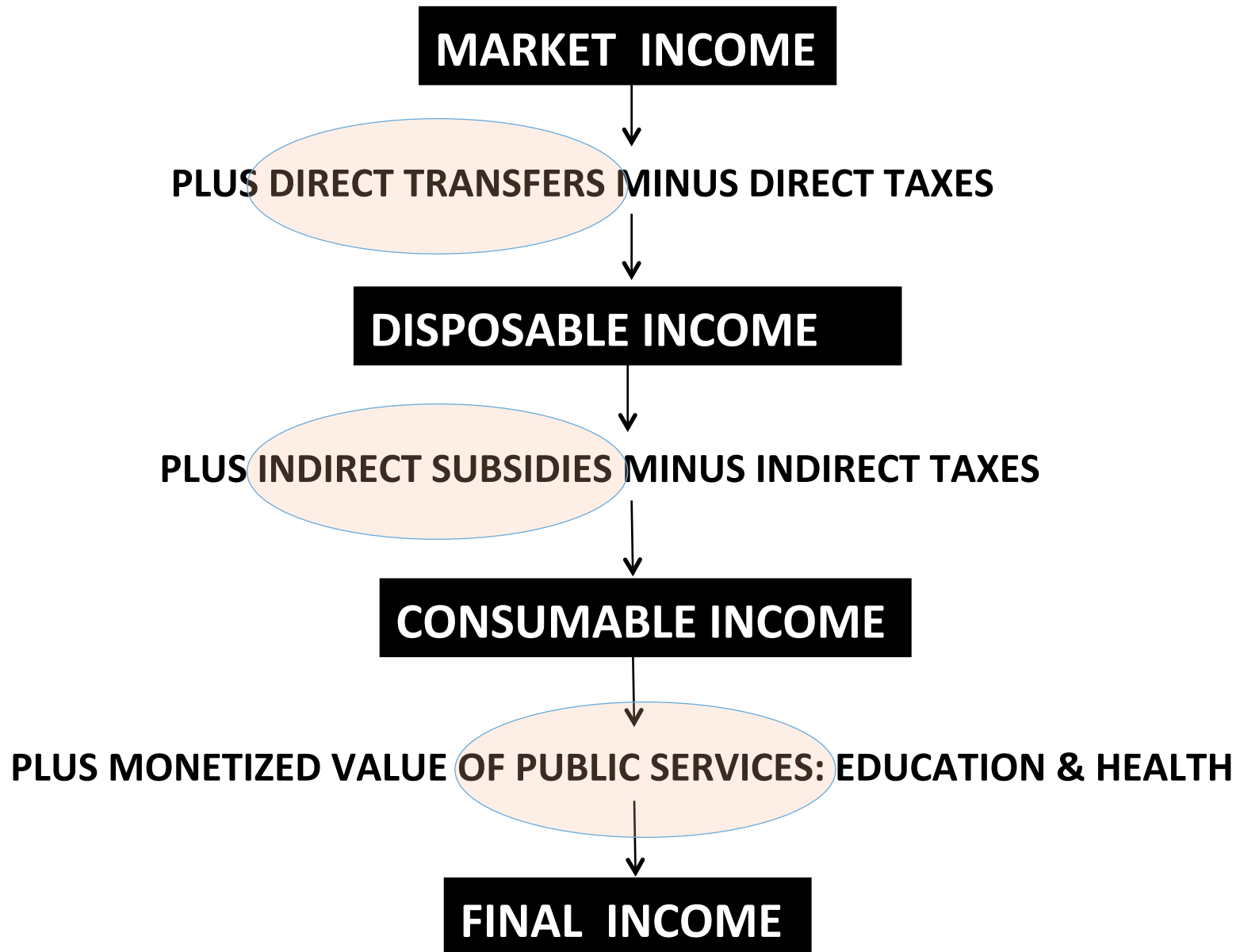


CEQ Assessment: Income Concepts



Higgins and Lustig. "Allocating Taxes and Transfers, Constructing Income Concepts, and Completing Section C of CEQ Master Workbook" in Lustig (editor) *Commitment to Equity Handbook. A Guide to Estimating the Impact of Fiscal Policy on Inequality and Poverty*, Tulane University, Fall 2016.

Where is Social Protection?



CEQ Assessment: Method

- Comprehensive standard fiscal incidence analysis of current systems
- Harmonized definitions and methodological approaches to facilitate cross-country comparisons
- Uses income/consumption per capita as the welfare indicator
- Allocators vary => full transparency in the method used for each category, tax shifting assumptions, tax evasion
- Secondary sources are used to a minimum

Fiscal Incidence in CEQ Assessments

- Accounting approach
 - no behavioral responses
 - no general equilibrium effects and
 - no intertemporal effects
 - but it incorporates assumptions to obtain economic incidence (not statutory)
- Point-in-time
- Mainly average incidence; a few cases with marginal incidence

Allocation Methods

- Direct Identification in microdata
 - However, results must be checked: how realistic are they?
- If information not directly available in microdata, then:
 - Simulation
 - Imputation
 - Inference
 - Prediction
 - Alternate survey
 - Secondary sources

Tax Evasion Assumptions

- **Economic burden of direct personal income taxes is borne by the recipient of income**
- **Burden of payroll and social security taxes is assumed to fall entirely on workers**
- **Consumption taxes are assumed to be shifted forward to consumers.**

Strong assumptions implying labor supply & consumer demand are perfectly inelastic; provide a reasonable approximation.

Exceptions (VAT reforms) might call for alternative assumptions (homothetic preferences).

Tax Evasion Assumptions: Case Specific

- Income taxes and contributions to SS:
 - Individuals who do not participate in the contributory social security system are assumed not to pay them
- Consumption taxes - varied
 - Place of purchase: informal markets are assumed not to charge them
 - Some country teams assumed small towns in rural areas do not to pay them
 - Effective (not statutory) rates always used

Monetizing in-kind transfers

- In-kind (educ./health) expenditures monetized by “expenditure incidence” or “government cost” approach.
 - Per-beneficiary input cost obtained from administrative data (scaled) and allocated as average benefit.
 - How much would income have to be increased to pay for the public service at government’s cost?
- User fees/co-pays might :
 - Reduce the *net* benefit of public expenditures: consumption (at government cost) obligates households to make other budget-constrained choices
 - Be a tax – especially when imposed by a different level of government.

Treatment of Contributory Social Insurance Pensions

- Deferred Income?
- Government Transfer?

Treatment of Contributory Social Insurance Pensions: deferred income

- “Actuarially fair” systems:
 - Contributions are a form of forced savings (not a tax)
 - Pensions are deferred income (not a transfer)
 - However, there usually is redistribution within the system from:
 - High to low earners
 - From workers who contribute but don’t reach the required minimum of years as active contributors to workers who do
- Very difficult to measure with information in typical household surveys

Treatment of Contributory Social Insurance Pensions: as part of labor contract

- In systems where pensions of public sector employees are part of the labor contract in a competitive market:
 - Contributions are forced savings (not a tax)
 - Pensions are deferred income (not a transfer) regardless of whether the system is actuarially fair or not because pensions over and above capitalized contributions are remuneration.
 - Here there also might be some redistribution within the system from:
 - High earners to low earners
 - From workers who contribute but don't reach the required minimum of years as active contributors to workers who do
- Very difficult to measure with information in typical household surveys

Treatment of Contributory Social Insurance Pensions: as transfer

- In systems that are not actuarially fair:
 - Contributions are a tax
 - Pensions are transfers
 - There is redistribution within the system from:
 - High earners to low earners
 - From workers who contribute but don't reach the required minimum of years in the labor force to workers who do
 - AND from taxpayers (generally) to pension recipients

Treatment of Contributory Social Insurance Pensions: as transfer

However, what is the size of the “subsidy”?

- Correct/ideal: The difference between what people would have received based on contributions and what they actually receive
 - Household surveys do not usually have the information to calculate this
- In practice: income from contributory pensions are treated as a government transfer
- A more realistic alternative: consider the deficit of the Social Security system as the size of the subsidy and allocate it to individuals based on the distribution of pension income
 - Deficits that are part of transition from one system to another will exaggerate the impact

Treatment of Contributory Social Insurance Pensions in CEQ:

Two extreme scenarios:

- Deferred income in actuarially fair systems: pensions included in *pre-fiscal income* and contributions treated as mandatory savings
- Government transfer: pensions included among direct transfers and contributions treated as a direct tax