

Financing Social Policy

Previous chapters in Section two of the report have provided substantial evidence of the positive economic and social impact of expenditures on basic social services and social protection programmes. Although the value of such social policies in reducing poverty and inequality is recognized, concern over their affordability remains widespread.

As fiscal constraints and the costs of health and elder care grow, even mature welfare states have come under pressure in recent decades, leading to predictions of their imminent demise. For the most part, however, such states have managed to adjust their social systems to these pressures. Most developing countries, on the other hand, operate within more severe fiscal constraints. Moreover, globalization and accompanying neoliberal policy prescriptions have had a negative impact on public revenues, forcing governments to reduce expenditures, curtailing social spending severely. These trends have had a particularly strong impact on low-income and aid-dependent countries.

A clear case can be made for increasing investments in social protection and social services in order to make meaningful dents in the multiple manifestations of poverty

In light of the positive development synergies explained in previous chapters, a clear case can be made for increasing investments in social protection and social services in order to make meaningful dents in the multiple manifestations of poverty. The United Nations Millennium Project recognized this in calling on most developing countries to mobilize up to an additional 4 per cent of their gross domestic product (GDP) to promote poverty reduction.¹

Such funds can be raised from a variety of sources: internally via taxation and social insurance schemes, externally in the form of aid or, in the case of mineral-rich countries, by taking advantage of favourable commodity prices and channelling rents into social programmes. Social protection and social services can also be financed privately through household income, including transfers from migrant workers, and unpaid work. Obviously such public and private sources lead to significant differences in terms of outcomes. This chapter analyses the contrasting effects of different financing sources and instruments on social development, equality and poverty outcomes.

The availability of resources to finance social policies depends on a country's economic performance, including its capacity to produce income and savings and to generate government revenues; the performance of its domestic capital markets; and the availability of external funding such as foreign investment, loans or grants. A dynamic economic environment and a stable world economy are therefore key determinants of national public finances, and it is here that the global economic crisis has had severe consequences for developing countries. Many are faced with sharply declining private and public revenues and falling growth rates due to a decrease in foreign capital inflows, domestic credit and remittances, falling commodity prices and worsening terms of trade. Mobilizing additional resources or even maintaining existing levels in such a context is a major challenge. Nonetheless, in response to the crisis, many countries are making efforts to implement social protection programmes alongside fiscal stimulus packages. Meanwhile, the international donor community has made commitments to increase development assistance.

Mobilizing resources is, however, only part of the battle. Decisions about revenue policies and the allocation of public funds are the result of political processes,

often dominated by elite groups. Consequently, such policies may not lead to the best outcomes in terms of providing public goods and reducing poverty (see chapter 11). Furthermore, institutional capacity, including the quality and efficiency of public administration and service providers, influences how successfully resources are translated into social outcomes (see chapter 10).

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The analysis in this chapter points to four main conclusions.

- To significantly reduce poverty, more funds have to be invested in universal social policies, especially in low-income countries.
- Domestic financing instruments such as taxation and social insurance can create synergies between economic and social development and strengthen democracy and solidarity within states.
- Other financing sources, such as aid, remittances and mineral rents, can play an important role in complementing domestic resources. This is especially true in low-income countries characterized by high degrees of informality, low tax revenues and low coverage of social insurance schemes.
- The ultimate challenge is to build social programmes on financial arrangements that are themselves sustainable in fiscal and political terms, equitable and conducive to economic development.

Section 1 of the chapter describes how social expenditures and public finances vary according to income level and policy regime, how they have been affected by globalization and why social policies are affordable even for low-income countries.

Section 2 focuses on the links between different revenue sources and financing instruments and the various dimensions of social policy – redistribution, reproduction, production and protection.

Section 3 analyses the impact of selected revenue sources on development outcomes and equality across various social policy regimes and development contexts. It compares domestic resources such as taxation, social insurance contributions and pension funds with sources such as mineral rents, aid and remittances.

Section 4 highlights policy lessons and remaining challenges, particularly with regard to the political economy of financing social policy.

1. Spending on Social Policy

Social spending reflects both national incomes and policy choices

In general, public social expenditure as a share of GDP rises with income, with high-income countries in the North spending the most. However, countries with a comparable income level display significantly different levels of expenditure on social protection and social services.² Within member countries of the Organisation for Economic Co-operation and Development (OECD), for example, Sweden spends as much as 30 per cent of GDP on cash benefits and social services, whereas the United States and Ireland spend only half that amount (around 16 per cent). Middle-income countries such as Mexico and the Republic of Korea spend between 6 and 7 per cent – lower than their respective regional averages of 12.7 per cent for Latin America and 8.4 per cent for emerging economies in Asia.³ Within the same region, Brazil and Mexico, both middle-income countries, spend 13.2 and 3.5 per cent, respectively, of GDP on social protection. Mongolia spends 10.5 per cent versus 1.9 per cent in Indonesia (see table 8.1).

TABLE 8.1: Government expenditure on social protection, social insurance and social assistance (% of GDP)

Country	Year	Social protection	Social insurance	Social assistance
Argentina	2004	9.2	7.7	1.5
Brazil	2004	13.2	11.7	1.4
Mexico	2002	3.5	2.6	1.0
Guatemala	2000	1.8	0.7	1.1
Viet Nam	early 2000s	3.5	1.9	0.5
Mongolia	early 2000s	10.5	7.8	1.1
Indonesia	early 2000s	1.9	1.3	0.3

Note: Social protection expenditure includes public expenditure on social insurance and social assistance, as well as other programmes, such as housing, municipal and community services. Source: Barrientos 2010.

The amount of public resources channelled into social sector policies is determined by the availability of funds and policy priorities, but administrative effectiveness also plays a role. As the case studies throughout this report show, the size of government spending is also determined by the division of labour between the state, markets and households in providing social services, which, in turn, is strongly influenced by a country's policy regime.

As discussed previously in this report, the amount of social expenditure does not reveal how much of this money actually reaches lower income groups or how effective these expenditures are in reducing poverty or increasing equality (see chapters 5 and 6). Nonetheless, a comparison of the shares of public social expenditure in domestic income demonstrates two important points: first, that social expenditure is clearly a policy variable and, second, that the amount of resources invested in social policy (and, most importantly, how they are spent) is determined largely by the policy regime in a country, rather than its income level. High-expenditure levels in former socialist countries, such as Mongolia, and in welfare state pioneers in Latin America, such as Argentina and Brazil, illustrate this point (see table 8.1).

The amount of resources invested in social policy – and how they are spent – is largely determined by a country's policy regime

The global context influences the financing of social policy

Following the debt crises in the early 1980s, many developing countries, particularly in Latin America and sub-Saharan Africa, were forced to undertake significant fiscal adjustments. The radical rethinking of the role of the state and fiscal expenditures during this phase of neoliberal reform undermined the interventionist policies of developmental states, leading to the withdrawal of the state from many policy areas and the retention of only a residual role in social provisioning. This paradigm shift led to the substantial privatization of social programmes, public sector retrenchment and considerable decreases in social expenditures. The reforms had differing effects on public budgets: in some cases the privatization of public enterprises led to

transitory inflows of capital, whereas in the case of pension privatization, considerable fiscal costs over several decades were incurred (see below). In addition, government revenues fell as liberalization policies and international tax competition led to shrinking revenues from trade taxes and levies on mobile production factors such as capital. Economic crises and recessions also had adverse effects on public accounts due to a combination of higher expenditures (including social transfers, economic subsidies and debt service) and lower fiscal receipts, a scenario that is once more a reality for many countries affected by the global economic crisis.

Even when countries managed to maintain expenditure levels as a percentage of GDP or the budget, especially for health and education,⁴ per capita expenditures fell each time an absolute decline in per capita GDP occurred.⁵ Overall, fiscal policy has been highly procyclical in Latin America and sub-Saharan Africa, reducing states' capacities

to protect the vulnerable and the poor. East Asia's fiscal policy, on the contrary, has been more countercyclical in the post-Asian crisis period, with social expenditures increasing during economic downturns.⁶

During the last decade, some countries, especially those that performed weakly with regard to domestic revenues, have seen increases in other types of revenues, such as development aid, remittances and natural resource rents. Increasing numbers of international migrants (usually escaping from adverse economic conditions in their country of origin), temporarily booming commodity prices (especially for selected minerals, oil and gas) and global initiatives to increase aid (including the Highly Indebted Poor Countries/HIPC initiative which aims to free up resources through debt relief) are at the heart of this trend. The questions then become how different sources of finance affect social development and how financing policies can be made more sustainable and equitable.

BOX 8.1: Social policy is affordable – for all countries

Evidence that social policy is affordable, even for countries with low levels of income, has recently been provided by research conducted by the International Labour Organization (ILO). A basic social protection package (comprising pensions for the elderly and the disabled, child benefits and essential health care) for low-income countries, such as Bangladesh, India, Kenya and Pakistan, was estimated to cost around 10 per cent of GDP. Although this is more than most of these countries currently spend, it is less than the average now spent on social protection in transition countries in Eastern Europe and Central Asia and some Latin American countries. It is also far below the average spent by OECD countries, which stands at 17.3 per cent of GDP.

In a similar vein, a recent UN study of 18 countries in Latin America and the Caribbean suggests that the Millennium Development Goals (MDGs) would be achievable for all countries in the region if they mobilized additional MDG-related public spending of between 0.9 and 6.1 per cent of GDP per year until 2015.

Sources: Pal et al. 2005; Clements et al. 2007; Vos et al. 2008.

2. Revenue Sources and Their Impact on Development

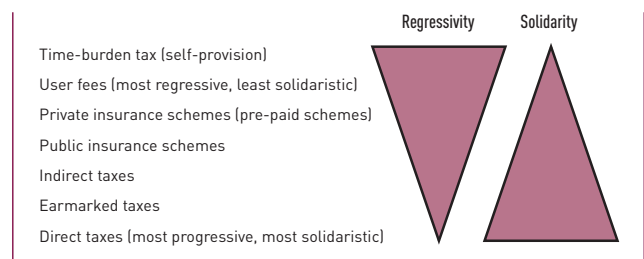
As discussed in previous chapters, adequate levels of social protection and the universal provision of essential social services can improve the distribution of income and assets in a society, transform gender relations and help reconcile the burden of reproduction with that of other social tasks. They also enhance the productive potential of members of society and protect people from the vagaries of the market and the changing circumstances of age. Achieving universal social policies and ultimately reducing poverty and inequality in developing countries requires that both expenditure and revenue policies respond to the principles of equity, gender equality, progressive redistribution and sustainable economic development. This section analyses how different revenue sources and financing mechanisms relate to these principles and dimensions of social policy.

Expenditure and revenue policies need to be equitable, progressive and sustainable

Different financing instruments affect redistribution and reproduction in different ways

Financing instruments can be classified according to whether they are distributionally progressive (redistributing from rich to poor), neutral or regressive, or based on normative principles of individualism or solidarity (see figure 8.1). For any level of resources, financing instruments become preferable as their progressiveness increases (in terms of redistributing resources towards lower income, disadvantaged or vulnerable groups, including ethnic minorities, rural dwellers, children, the elderly and the chronically ill).

FIGURE 8.1: Revenue type, distribution and social relations



Source: Based on Delamonica and Mehrotra (2009).

Financing social policies through self-provisioning, user fees or cost sharing

In the case of domestic financing sources, as figure 8.1 indicates, the most regressive and individualistic forms of financing for social services or social protection are those in which people provide for themselves (self-provisioning) or that require out-of-pocket payment of user fees. Self-provisioning means that households and families provide their own services, or smooth consumption in the event of income shocks by performing unpaid care work, drawing down savings, selling household assets or increasing their paid labour. User fees include informal payments to health care providers at the point of service and cost sharing, the latter requiring the individual to pay part of the cost of the health care actually received. Cost sharing, whether in the form of a fixed or proportional amount per service received, is therefore different from the payment of an insurance premium, contribution or tax, which is paid whether health care is received or not. Particularly during the 1980s, user fees were promoted by the international financial institutions (IFIs) as mechanisms for raising additional revenues and improving access, efficiency and quality of social services, such as health care and education. It was also thought that people would value services more if there was some notional fee attached to them (see chapter 6).⁷

The evidence, however, suggests that the adoption and expansion of user fees has not resulted in these potential benefits (see chapters 5 and 6).⁸ In fact, user fees are linked to a decline in the utilization of services, with adverse

effects on equity. Any redistribution that takes place is usually limited to members of the same household, rather than across different income and risk groups, and is often to the disadvantage of women and girls within households (see chapters 4 and 7).

Pre-paid schemes and public social insurance

Private insurance or pre-paid schemes, in which contributions are collected before a contingency occurs, are superior to user fees paid at the point of use in terms of both risk pooling and administrative costs, which tend to be lower if schemes allow for economies of scale. Insurance contributions, whether private or public, can be a fiscally neutral way of financing social protection, because the insurance principle establishes a close link between contributions and benefits, based on the risk profile of the insured and possible dependants. However, flat rate contributions are regressive, and even proportional contributions levied as a percentage of salaries usually do not apply to incomes earned from investments and saving. Moreover, insurance schemes, whether private or public, are less redistributive in gender terms than general revenues. This is because women tend to have lower earnings and less stable work and earning trajectories due to their reproductive and caring roles and, especially in developing countries, because they are concentrated in low-paid informal jobs.

With regard to private programmes, redistribution is limited to risk pooling, making them a more expensive option for low-income earners and families unless the state intervenes to provide subsidies. Public social insurance is more effective in increasing solidarity and redistribution. This is especially true if the system is financed through progressive payroll taxes, if contributions are shared between workers and employers, and if subsidies are provided for disadvantaged groups of the insured.

Indirect taxes levied on consumer goods and services

Indirect taxes levied on consumer goods and services (sales tax or value added tax/VAT), trade or specific products (excise tax) are more regressive than progressive income taxes. They are also more problematic in terms of gender,

since lower income groups and women spend a higher share of their income on these goods and services.⁹ In theory, taxes such as VAT can include exemptions for goods and services related to basic needs and impose higher rates on luxury goods in order to make distributional effects more progressive and gender neutral.

Direct taxation of personal and corporate income and of property

Finally, direct taxation of personal and corporate income, along with property, is the most redistributive and gender equalizing way of mobilizing revenue. This is especially true if couples are taxed as individuals, if the system does not discriminate against single female-headed households, if marginal tax rates increase with income, and if no exemptions and allowances are granted for high income earners.¹⁰

Thus, governments have a variety of domestic financing instruments to choose from, ranging from regressive forms of self-provisioning to public transfers and services financed by direct progressive taxation, which entails potential gains with regard to distributional justice and social reproduction. In many developing countries, however, the more progressive options are constrained by a widespread informal economy, lower administrative capacity and the entrenched power of domestic economic elites and external investors to negotiate favourable tax conditions.

Mineral rents, remittances and aid

The impact of mineral rents, remittances and aid on redistribution and gender equality is more complex and is mediated by a number of context-specific factors. For example, the effect of mineral rents on redistribution and reproduction depends on the fiscal regime and social policy system in place in a country, which determine how rents from mineral wealth are extracted and redistributed. Moreover, the concentration and enclave nature of the extractive sector, coupled with the type of manual work involved in it, are less likely to contribute to more equal gender opportunities in a given country.

While sustaining the social and economic reproduction of migrant-sending communities, remittances can transform

but also reinforce existing inequalities and social structures, such as gender relations, care arrangements, class and ethnic hierarchies.¹¹ As international migration is a selective process, most direct benefits of remittances are also selective and do not tend to flow to the poorest members of communities, nor to the poorest countries.¹² In general, data suggest that the non-poor often benefit more, and remittance inflows can initially lead to increasing inequality. However, the poorest people might benefit indirectly through positive effects of remittance expenditure on wages, prices and employment in the communities and countries from which migrants originate.

Remittances can transform but also reinforce existing inequalities and social structures

Aid represents a form of international redistribution of resources. However, its redistributive impact at the national level depends on the type of instrument used (loan or grant), the sector it is intended to support (such as social services, infrastructure, rural development or capacity building), and the way in which it is channelled (through budget support, project funding or non-governmental organizations/NGOs). Furthermore, its redistributive effects depend on the conditionalities attached to it, which can include provisions related to mainstreaming gender equality. In particular, the payment of interest on loans in low-income countries is not likely to have positive redistributive and equity-enhancing effects when the local fiscal regime relies disproportionately on indirect taxes, overburdening low-income citizens and women.

Different financing instruments affect production and protection in different ways

The conventional view on public finance dominated by neoclassical economists tends to separate funding from expenditure policies and to ground them in different principles. Revenue policies, according to this view, should be

guided by efficiency norms rather than distributing from the rich to the poor, in order to minimize adverse incentives for domestic demand, labour supply, savings and investment. Redistribution should then take place through targeted expenditure policies and not through taxation or social insurance schemes. However, while some economists see possible distortions that could undermine efficiency and growth, others consider the so-called automatic stabilizers – progressive tax-transfer schemes – as a means to combining redistribution with macroeconomic stabilization. In addition, as shown in chapter 5, social insurance programmes financed through contributions can support economic development in a variety of ways. For example, funded social protection schemes such as pension funds can be a source of finance, stimulating financial sector development and, in the case of occupational funds, providing “patient capital” (long-term financing) and wage moderation to firms, while supporting employment stability and incentives for workers to invest in industry-specific and/or firm-specific skills.¹³

An additional concern is whether domestic resources have a different impact on economic development when compared to alternative or external resources. Export earnings or private and official transfers and loans (in the form of official development assistance/ODA, and remittances) are denominated in foreign currency and have a potentially negative effect on macroeconomic stability. In addition, aid – grants and low-interest loans – is subject to conditionality, while loans might adversely affect debt sustainability. Remittances, on the other hand, are difficult to tap because of the private and often informal nature of these flows. The fact that these resources are of growing importance to many developing countries, especially lower income countries, justifies a closer analysis of their potential and challenges.

The impact of different revenue sources on protection depends on how revenues are used. Revenues are usually not tied to a specific spending purpose and are fungible, except for the case of earmarked taxes, social insurance contributions and aid targeted to social provisioning. Consequently, the impact of any revenue source on protection depends on the level, type (public versus private) and structure (sector) of social expenditure it finances. The social policy regime

determines the extent to which revenues are invested in public or private provision, universal or targeted social programmes, which implies different ways of protecting against a range of individual and market risks with different outcomes (see chapters 5 and 6). Concrete examples of how the relationship between revenue sources and protection plays out are examined in the following section.

3. Mobilizing Resources for Social Policy

How have countries mobilized resources in different national contexts and a changing global environment? This section illustrates, through specific country experiences, the relative importance of each of the revenue sources discussed above in terms of their impact on social development and social policy. The findings suggest that domestic resources should form the bedrock of revenue policies, while remittances, aid and mineral rents, if properly managed, can provide additional funds for investments in social policy.¹⁴

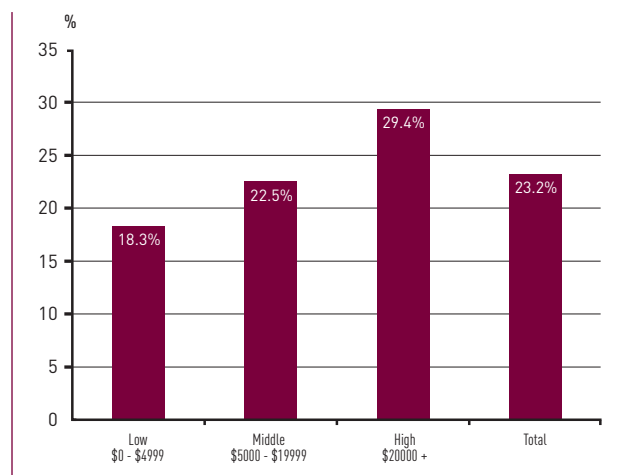
Designing equitable and efficient tax systems is key to development

In developing countries, designing equitable and efficient tax systems is key to financing social policy in a context of consistent national development strategies and strong state-citizen relationships. The mobilization of domestic resources through tax reform was considered a pillar of the 2002 Monterrey Consensus on Financing for Development and its follow-up declaration in Doha in 2008.¹⁵ It is also recommended as the principal financing strategy (together with limited public and foreign borrowing, reallocation of funds and efficiency-enhancing measures) for Latin America and the Caribbean for achieving the MDGs.¹⁶ Taxation revenue is generally deemed superior to other sources because of its stability and its potential for distributional justice and for financing programmes with universal coverage. Tax systems are also said to enhance state

ownership and accountability as compared to external revenues, which in the case of aid, for example, is tied to donor conditionality, therefore bypassing national constituencies and political institutions (see chapters 10 and 11).¹⁷

While tax shares tend to grow as GDP does (see figure 8.2), important variations can be found within each income group.¹⁸ The Netherlands and Sweden collect over 45 per cent of GDP in taxes. In Japan and the United States, the share is less than 40 per cent; in Brazil and South Africa, it is over 35 per cent; and in Colombia and Mexico, less than 15 per cent (all include social insurance contributions). How can these differences be explained?

FIGURE 8.2: Tax revenue as a percentage of GDP in low-, middle- and high-income countries



Source: Bird and Zolt 2005.

Tax capacity in developing countries is determined by the level of development, economic structure (size of the informal sector, size of wage employment, share of agriculture or primary products, reliance on trade), institutional legacies, and political-institutional factors such as state capacity, credibility and what could be labelled tax effort. In many countries, trade liberalization policies have led to the shrinking of total tax revenues, despite the fact that efforts were made to make up for losses through new and supposedly less distortionary taxes, such as consumption taxes. Several studies¹⁹ show mixed results for the recovery

of lost trade revenues, but the positive trends largely reflect gains in middle-income countries from the implementation of VAT.²⁰ In contrast, low-income countries, by and large, have not enjoyed revenue gains from such taxes due to problems with refund and credit mechanisms, underpayment and high levels of informality.²¹

Recent tax reforms have not only led to shrinking tax revenues; they have also switched the overall tax structure towards more regressive consumption taxes. Table 8.2 shows that revenue from VAT as a percentage of GDP increased in Latin America, East Asia and South Africa between the second half of the 1970s and 2002. Meanwhile, in Latin America, personal income and property taxes, and taxes on

corporate income, profits and capital gains have, on average, fallen. Tax revenues have also been negatively affected by economic crises, de-industrialization and growing informalization – particularly in Latin America, sub-Saharan Africa and transition economies.

Tax systems across regions and selected countries

East Asia. In East Asia, tax rates, especially payroll taxes for social insurance, have been moderate to low. However, a diversified tax structure, high compliance and positive economic performance in recent decades have resulted in relatively high and increasing tax receipts, especially with regard to progressive direct taxation (see table 8.2), which is now three to four times higher than in Latin America.

TABLE 8.2: VAT; taxes on corporate income, profits and capital gains; and taxes on personal income and property (% of GDP)

Countries	Value added tax (VAT)			Tax on corporate income, profits and capital gains			Personal income and property tax			Per capita GDP in 2000
	1975–1978	1985–1988	1997–2002	1975–1978	1985–1988	1997–2002	1975–1978	1985–1988	1997–2002	(in 2000 \$)
Argentina	1.1	1.8	3.8	0.7	0.8	2.2	0.4	0.8	1.1	7,726
Brazil	0	8.7	12.1	3.2	4.4	4.5	0.2	0.2	1.4	3,537
Costa Rica	1.6	2.8	4.8	2.8	2.4	2.8	2.9	2.2	0.7	4,185
Republic of Korea	2.6	3.5	4.1	4.2	4.8	5.5	1.9	2.8	3.6	10,890
South Africa	1.2	6.1	6.1	12.9	13.1	14.6	n.a.	n.a.	n.a.	n.a.
Taiwan Province of China	n.a.	n.a.	n.a.	4.0	4.8	6.6	3.4	4.5	5.2	13,985
East Asia (average) ^a	2.0	2.3	2.9	5.7	6.0	6.9	1.8	2.3	3.9	3,716
Eastern Europe (average) ^b	n.a.	n.a.	7.4	n.a.	n.a.	8.3	n.a.	n.a.	6.8	4,327
Latin America (average) ^c	2.5	3.6	5.6	5.0	4.1	3.9	1.7	1.2	1.0	4,399

Notes: ^a Average includes countries and areas for which data were consistently available: Indonesia, Malaysia, the Philippines, Republic of Korea, Taiwan Province of China and Thailand. ^b Average includes countries for which data were consistently available: Czech Republic, Estonia, Hungary, Latvia and Poland. ^c Average includes countries for which data were consistently available: Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Venezuela. n.a. = not available. Source: Di John 2008. Data for Taiwan Province of China are from Directorate General of Budget, Accounting and Statistics, Executive Yuan, Taiwan, China (2002).

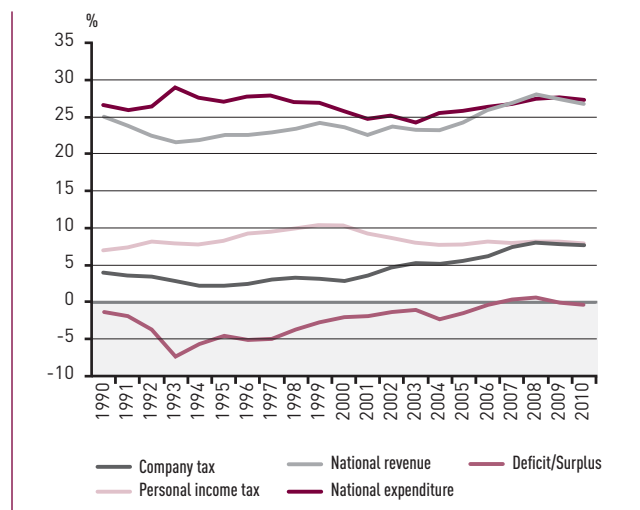
The Republic of Korea and Taiwan Province of China show the highest rates of progressive income tax, whereas direct taxes are considerably lower in Hong Kong, China and Singapore. In Taiwan Province of China, similarly to the Republic of Korea, democratization brought some fundamental changes to the local fiscal policy, which has become much more expansive in an attempt to finance a new emerging welfare state.²² In comparison to other regions of the developing world, Asia – East Asia in particular – still benefits from healthy fiscal balances. This inheritance provided states with more options to expand public insurance and services as democratization and world market integration advanced,²³ with scope to increase tax rates to mobilize higher public revenues.

Brazil and South Africa. These two middle-income countries, featuring dualistic structures in both their economic and social systems, exhibit high tax-to-GDP shares when compared to their regional averages (see tables 8.2 and 8.3). In the case of Brazil, tax receipts as a percentage of GDP increased from 17 per cent in 1980 to 21.1 per cent in 2004. When social security contributions are included, they rose from 22.7 to 35.9 per cent, with the highest receipts obtained from the value added communication and transportation tax collected at the state level.²⁴

Tax policy in Brazil is caught between competing demands. On the one hand, it is shaped by relatively orthodox economic policies aimed at higher revenues in order to service Brazil’s huge debt and to achieve budget surpluses for the purpose of macroeconomic stabilization. On the other hand, it is confronted with social demands due to persistent problems of poverty and inequality. More recently, Brazil is among the countries aiming at a gradual rebalancing of expenditure, away from social insurance and towards social assistance (see chapter 5).²⁵ The country is also experimenting with forms of direct involvement by citizens in the budget process (see chapter 10). In Porto Alegre, the support of the Workers’ Party has been central to the success of participatory budgeting initiatives, which have raised the legitimacy of local government among the poor and middle classes, created more and better pro-poor expenditure, and raised local tax collection from wealthier groups.²⁶

In South Africa, institutional legacies, a strong party system, and strong economic growth (when compared to the rest of sub-Saharan Africa) have all contributed to positive tax performance. In addition, the South African Revenue Service has successfully managed to broaden the tax base and to improve tax compliance.²⁷ Increased revenue, in combination with decreasing expenditure, has helped to reduce the fiscal deficit, as figure 8.3 shows. With 14.6 per cent of GDP in tax receipts from corporate income, profits and capital gains (see table 8.2), South Africa holds the highest rank in the developing world. The South African fiscal system, on both the revenue and expenditure sides, is considered to be fairly progressive. National studies of fiscal incidence demonstrate that there is considerable redistribution through the budget, from rich taxpayers to poor households, especially through old-age pensions, other welfare programmes and educational spending.²⁸ Personal income tax has declined as a proportion of GDP, but company tax has risen. Overall, direct taxes (57 per cent of total) have risen slightly, whereas indirect taxes have fallen (comprising 43 per cent).

FIGURE 8.3: Fiscal indicators in South Africa (as % of GDP)



Source: Seekings and Natrass 2008.

India. Largely due to the informal nature of the Indian economy, tax revenue accounts for a low 15 per cent of GDP. High dependence on indirect taxes in combination

with multiple exemptions for direct taxes on income and profits indicate that the overall structure tends to be regressive. Incomes below a threshold of \$206 per month are exempt from taxation, narrowing the tax base to around 40 million taxpayers.²⁹ Additional factors contributing to the low tax intake are the lack of a social security system, the large informal sector, large-scale evasion and legal tax avoidance via exemptions and incentives, as well as tax reforms reducing tariffs, especially on trade. Improved tax administration and compliance are considered of crucial importance in raising public revenues in India. Also, from the point of view of equality and growth, there is ample room to improve the system, which at present largely favours bigger enterprises and higher income groups.

Mineral-rich countries. The diverse group of mineral-rich countries, including Norway (one of the richest countries in the world), many middle-income countries such as Chile and Malaysia, as well as very poor countries such as Angola, Bolivia and Chad, also reflect huge differences in existing welfare systems and underlying fiscal and tax regimes.³⁰ As table 8.3 shows, many of the higher tax states in sub-Saharan Africa, such as Botswana, Nigeria and Zambia, are in fact mineral-rich countries, receiving the bulk of their revenues from the minerals sector. In contrast, trade and, more recently, consumption taxes are relatively more important in the group of so-called merchant states – countries relying on export of primary products, such as Kenya and Senegal.³¹

TABLE 8.3: Tax collection and composition in selected sub-Saharan African countries

	Years	Tax revenue (% of GDP)	Trade taxes (% of total taxes)	Per capita GDP (2000 market prices, \$)
Lower tax countries				
Chad	1994–2000	6.5	34	801
Democratic Republic of the Congo	1998–2002	4.5	32	600
Ethiopia	1993–1997	12.9	40	814
Mozambique	1993–1999	11.4	18	799
Niger	1994–2000	7.9	57	678
Uganda	1998–2003	11.4	16	1,167
United Republic of Tanzania	1992–1999	9.6	35	524
Average		9.2	33.1	769
Higher tax countries				
Botswana	1993–1998	32.5	18	8,347
Kenya	1992–2001	23.1	17	1,033
Nigeria	1992–2000	15.2	18	854
Senegal	1992–1998	16.0	28	1,427
South Africa	1998–2002	25.5	13	8,764
Zambia	1990–1999	18.1	12	785
Average		21.7	17.7	3,535
Average excluding Botswana and South Africa		18.1	18.8	1,025

Source: Di John 2008.

Within Latin America, Chile, one of the world's leading copper producers, is also among the group of relatively strong tax states. Tax receipts from mining account for roughly 35 per cent of total fiscal revenues, and more than half of these receipts originate from CODELCO, the state-owned Chilean copper company.³² After extensive public debate on the capture of mineral rents by the private sector, which benefited from extensive tax privileges in the past,³³ a specific tax on mining activities (the so-called Royalty 2) was introduced in 2005. As a result, \$544 million was collected in 2006 and \$730 million the following year.³⁴

Taxation as a social contract between citizens and the state

The analysis presented in this chapter highlights the importance of recognizing taxation as an intrinsic dimension of the state, and the need to design tax systems that reflect a social contract that inextricably links citizens and the state. There is a clear case as to why progressive forms of taxation are best suited to foster nation building and social cohesion over the long term, although it is well known that direct and progressive taxation policies are difficult to implement in a context of highly unequal distributional patterns, low wages, a predominantly informal economy, and low state capacity and legitimacy.

Progressive forms of taxation are best suited to foster nation building and social cohesion over the long term

More than with other revenue sources, therefore, it is critical to establish a culture of taxation based on mutual trust, and to adapt systems to local circumstances. This tends to make tax reform a long-term endeavour rather than a quick fix. Furthermore, this means that, at times, taxing exports or land or establishing marketing boards can serve as a functional equivalent to taxing landowners or high-income earners directly (see chapter 10).³⁵ The surplus generated by marketing boards, to give an example, was often similar to total tax collection from other sources, especially

in sub-Saharan Africa in the 1960s and 1970s. It should, however, be acknowledged that not only rich peasants but also many rural poor were taxed by the controlled price policy of the boards. As a second possible device, earmarked taxes, although criticized by some economists for reducing the fiscal autonomy of the government, can be another way of fostering political support for new revenues.³⁶ The challenge is to find ways of guaranteeing that both parties – taxpayers and the state – will comply. The latter also calls for coordinated action at the international level to complement national efforts for reducing tax avoidance and tax evasion, which has been estimated to account for revenue losses of \$385 billion per year in developing countries.³⁷

Extension of social insurance schemes is a challenge for developing countries

Social insurance schemes are a common instrument to finance and provide social transfers. They can be initiated on a small scale and gradually extended to other groups of citizens as the formal economy expands, as shown in chapter 5. Nevertheless, the fact that demographic change and, more recently, labour market flexibility are resulting in shrinking numbers of active contributors and growing numbers of beneficiaries raises a key question: how can extending social insurance programmes become a viable financial option for developing countries?

In most countries, the supposed attraction of contribution-financed schemes – their fiscal neutrality – no longer holds true. Increasing subsidies to make up for deficits, unless explicitly used to incorporate low-income groups (see chapter 5), not only creates a fiscal problem, but is also questionable in terms of equity: most low income earners in developing countries are excluded from formal social insurance programmes. If these programmes benefit from subsidies financed via general revenues, regressive redistribution might take place, especially if subsidies benefit special programmes such as civil servants' pensions (see chapter 5), and the tax system relies heavily on consumption taxes.

Pension funds: A balance between social protection and development

Social insurance programmes can be set up for contingencies, such as sickness, disability and death of the main breadwinner, old age, work accidents and unemployment. This section concentrates on pension insurance, given its relevance in terms of competing reform models and the magnitude of funding involved. Pension insurance can be organized according to different models, such as public, private or occupationally based (enterprise-related) insurance schemes. They can be further broken down into funded schemes, in which benefits depend on past contributions and the individual characteristics of the insured, and redistributive (pay-as-you-go/PAYG) schemes. Both models are financed through contributions. In the case of PAYG schemes, such contributions are usually shared between workers and their employers and are ideally designed as progressive payroll taxes. The extent to which the state is involved in social insurance schemes depends on the characteristics of a country's social policy regime, ranging from basic normative and regulatory interventions, as in the case of East Asia,³⁸ South Africa and parts of Latin America,³⁹ to extensive financial contributions, as in the case of the Western European, former socialist and some Latin American welfare states.

At the macro level, pension funds have constituted a domestic source of finance. In Finland, for example, funds from the partially funded pension scheme were used in the post-war era for investments in housing, electrification of the country and to build up national industry.⁴⁰ The same applies to provident funds in East Asia. Such funds in Hong Kong, China; Malaysia; and Singapore have partly financed domestic investment, housing in particular, or contributed to stabilization through forced savings and investment of funds abroad.⁴¹ In successful cases, national pension funds have contributed to economic development, and their growth contribution has secured their own long-term solvency.⁴² In unsuccessful cases, the erosion of funds due to inflation and mismanagement or gradual depletion of funds in the case of maturing pension schemes has resulted in the conversion of funded schemes into PAYG systems.

In Finland, funds from the pension scheme were used for investments in housing, electrification and to build up national industry

Privatizing pension funds. Against this “natural” transition from pre-funding to PAYG financing, Chile, in 1981, chose the opposite sequencing. The country privatized the public pension scheme and introduced fully funded individual pension accounts for the insured. Since then, privately managed and decentralized funds have been created in a number of Latin American and Eastern European countries, as well as in China and in Nigeria.⁴³ These reforms have been justified on the grounds of efficiency and accumulation, as part of structural adjustment and greater reliance on markets.⁴⁴ It has been argued that these reforms will not only lead to greater personal savings and reduced fiscal burdens in the future, but will also contribute to the establishment of stock markets and deepening of the financial sector, which is considered necessary for efficiently allocating capital and promoting growth.⁴⁵

Privatizing pension funds raises a number of issues in the context of financing development. First, preconditions for implementing private schemes are demanding. Funded schemes are risky when financial and banking systems are not well developed and regulated, and they are especially vulnerable during financial and economic crises, as the recent situation forcefully shows. Chile lost almost 12 per cent of GDP in accumulated pension assets between 2007 and 2008.⁴⁶

The second issue for concern regards the actual investment of pension funds. In the case of transition from a public PAYG system, the majority of funds are invested in public debt in order to finance transition costs. Transition costs occur once contributors start paying into individual accounts and the public scheme is left without revenues, but still has to pay current pensions and compensate the insured, who switched to the private scheme, for their past contributions. In order for pension reform to remain

cost-efficient – one of the key objectives of pension privatization – governments must usually cut benefits and entitlements, potentially undermining social goals such as coverage, gender equality, income security and poverty reduction. The insured not only bear these costs as taxpayers and future beneficiaries, but they also shoulder high administrative costs associated with decentralized funds (in Latin America, these amounted to an average of 9 per cent of collected contributions in 2009),⁴⁷ considerably lowering rates of return on their pension savings.

In Chile, transition costs are spread over a 30-year period. They were as high as 4.7 per cent of GDP in 1984 and are expected to decline gradually until they reach approximately 1.5 per cent in 2010.⁴⁸ To close the rising coverage gap caused by privatization, Chile introduced a non-contributory basic pension and subsidies to low-income groups in 2008, at an estimated cost of around 1 per cent of GDP annually.⁴⁹ In the case of Argentina, the transition costs associated with the introduction of a second pillar of private pension accounts in 1994 caused a fiscal deficit that was deemed unsustainable in view of the country's monetary regime. These costs also prompted creditors to withdraw their funds in 2001, leading to the worst crisis in the history of the country (see chapter 5). After implementing several small reform measures to strengthen the public pillar of the Argentine pension system, the government finally opted to re-nationalize it. In the midst of international financial turmoil in November 2008, accumulated pension assets of approximately \$30 billion were transferred to the public sector. The government justified the reform by referencing numerous shortcomings of the private scheme, including its demonstrated vulnerability in times of financial crisis, and its objective of using the funds to reactivate the economy.⁵⁰ Critics suspect fiscal motives played a major role in the reform project, fearing funds could be decapitalized when used as a cheap financing instrument for the public sector (for example, if invested in securities with negative real interest rates), as has happened in the past.⁵¹

As shown above, the challenge with pension insurance is to strike a delicate balance between designing models guaranteeing adequate protection levels for the aged,

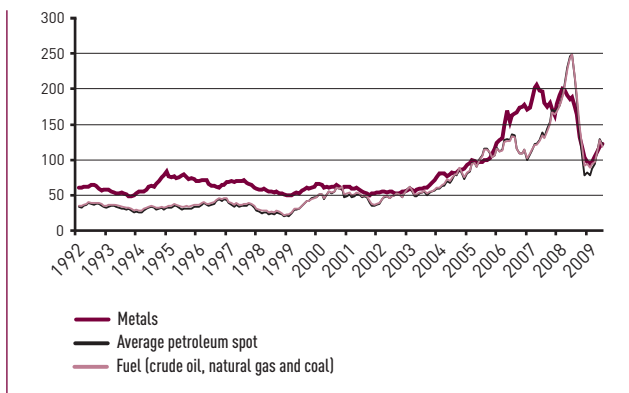
while also contributing positively to economic development and creating appropriate governance structures for these institutions. The stronger the economic and institutional environment, the more likely that pension systems will contribute to both objectives: social protection and economic development. Given the inherent risks and shortcomings of the private model, however, it seems reasonable to focus reform efforts on enhancing equity and efficiency in public PAYG schemes and on strengthening basic pensions that benefit the majority of the population.

The challenge with pension insurance is to strike a balance between guaranteeing adequate protection for the aged, while contributing to economic development

A wealth of mineral resources does not necessarily enrich people

If the lack of sufficient revenues is considered a major problem for social policies in developing countries, those countries that are richly endowed with natural resources, especially oil and gas, should presumably be fortunate. For many developing countries, natural resource rents represent a substantial and growing proportion of total government revenues, either by means of taxation or royalty payments or direct ownership, with potentially enormous implications for the design and delivery of social policies. Before commodity prices dropped in the context of the recent global economic crisis, these countries experienced a mineral bonanza (especially due to skyrocketing oil prices, as shown in figure 8.4), which could potentially produce a big push for the development process.⁵² Yet there is considerable evidence that many resource-abundant countries have not been able to utilize their resources to induce a process of sustained economic growth, let alone social development involving equitable distribution of the fruits of this natural wealth and overall improvements in the welfare of their citizens.

FIGURE 8.4: Monthly price index for commodity metals, oil and fuel, 1992–2009 (2005 = 100)



Note: Value of index in January each year. Source: UNRISD elaboration, based on data from IMF (2009).

Mineral-rich countries are often said to suffer from a “resource curse”, a supposed correlation between natural resource abundance on the one hand, and a set of negative economic, political and social outcomes on the other.⁵³

However, numerous resource-rich countries do not suffer from these symptoms, which points to the more interesting issue of explaining these variations in outcomes. The main task for research should therefore be to identify intervening variables, such as economic and social policies, or political institutions, that mediate the relationship between mineral-led development paths and developmental outcomes.

Overcoming the resource curse

One precondition for successfully tapping mineral wealth for social development is to avoid falling into the trap of “Dutch disease” (see box 8.2). This requires macroeconomic policies that counteract inflationary pressures arising from the huge inflow of foreign exchange stemming from the mineral sector, with negative effects on stability and the competitiveness of manufacturing. Equally important are investments in infrastructure, such as electricity and transport, and in technologies that reduce the adverse environmental effects of mining. Lastly, improved taxation systems and contracts with private investors are crucial to ensure a fair share of income for the state.⁵⁴

BOX 8.2: Mineral rents and “Dutch disease”

Dutch disease is one of the most extensively studied conduits through which revenue booms affect development in mineral-rich countries. It refers to a situation in which the real exchange rate appreciates in periods of resource booms, thereby negatively affecting competitiveness in non-mineral tradable sectors, in particular agriculture and industry. Dutch disease was first recognized in the Netherlands following that country’s discovery of natural gas in the North Sea in 1960. In 1976, gas revenue in the Netherlands amounted to \$5.5 billion, most of which was too quickly spent, pushing up internal demand and prices. This led to a strong guilder (then the Dutch currency). Subsequently, the manufacturing sector declined sharply and experienced a 16 per cent loss of employment. The state struggled to save jobs and to maintain its welfare commitments. By 1982, its budget deficit was 7 per cent of GDP.

Countries can act to prevent or mitigate Dutch disease: instead of spending windfall revenues on domestic non-tradables, they can buy imports or remove the money from circulation by saving it or paying off debt. In this way, the relative domestic price of tradables and non-tradables would remain the same, implying no change in the real exchange rate. Thus, real exchange rate appreciation is determined by the spending and savings decisions of governments. Dutch disease is thus as much a policy phenomenon as it is a macroeconomic one.

Source: Asfaha 2008.

Resource-rich countries such as Botswana, Chile, Indonesia, Malaysia and Norway have managed the challenge of Dutch disease reasonably well, applying different policy instruments. These include monetary sterilization, reserve accumulation, repayment of foreign debt, purchase of imports, forced savings through budget surpluses or creation of stabilization or pension funds, capital controls to reduce speculative short-term inflows, and social pacts to enforce wage restraint. However, some of these countries have not been as successful in terms of fostering democratic governance and equitable social policies. Chile, Indonesia and Malaysia have undermined democratic rights and civil society during long-term dictatorships or electoral democracies with one-party rule and with social policies whose main purpose was to legitimize authoritarian rule.

Resource-rich countries such as Botswana, Chile, Indonesia, Malaysia and Norway have managed the challenge of Dutch disease reasonably well

The Norwegian model

One way of using mineral windfalls to finance social protection schemes is to channel revenues into long-term pension funds. Doing so can simultaneously accomplish the two objectives of stabilization and social protection, at least during the build-up phase of the pension funds. In Norway, the Government Petroleum Fund established in 1990 (renamed the Government Pension Fund Global in 2006) is a model of such a policy. The aim of the fund is to ensure sustainable and transparent use of income from the oil sector by channelling all proceeds (in terms of tax revenue and gains from direct public ownership) into this fund. Accumulated wealth in the Government Pension Fund amounts to about \$400 billion, which is slightly less than Norway's annual GDP.⁵⁵ Since 2001, only 4 per cent

(the supposed long-term rate of return) of the fund has been transferred annually into the state budget. However, the fact that domestic investment of the fund is forbidden, which in normal times adds to macroeconomic stabilization, has been disastrous in the recent economic crisis: the fund incurred losses of over \$90 billion in 2008.⁵⁶

Among other factors cited as most relevant to Norway's success in overcoming the resource curse are the quality of its institutions; parliamentary democracy and active civil society; development of a technology-intensive industry for offshore drilling; high involvement of the Norwegian state, including direct ownership of the national oil company, Statoil; and the fact that Norway was already an advanced industrialized country when oil was discovered.⁵⁷ A considerable part of the country's oil wealth has been transferred to citizens in the form of increased welfare spending on social protection and social services, rather than through tax cuts or gasoline subsidies that tend to favour higher income groups.⁵⁸ The expansion of the welfare state has also been reflected in increased employment (especially among women) in the social sector, thus compensating for some job losses in the manufacturing sector.

Bolivia: Financing social pensions though mineral wealth

In contrast to Norway, mineral-rich developing countries such as Bolivia, Nigeria and Venezuela are characterized by intense pressure to spend revenues quickly in order to improve the intolerable living conditions of the majority of their populations. This is especially true if political leaders have been voted in on the basis of a popular platform that advocates redistribution of income. Such pressure often leads to social and political conflict, as the case of Bolivia clearly demonstrates.

Bolivia's first non-contributory pension scheme for the elderly, Bono Solidario or Bonosol, was financed by dividends generated from state-owned shares in a number of energy, oil, gas and communications enterprises privatized in the 1990s.⁵⁹ It paid an annual benefit of \$235 to people over 65. In 2006, oil and gas industries were re-nationalized and private companies compelled to sign new contracts with

the Bolivian state, thus undermining Bonosol's funding. A new and expanded universal pension, Renta Dignidad, replaced Bonosol in 2007. The scheme is financed through the direct hydrocarbons tax, a levy of 32 per cent on the production of hydrocarbons introduced in 2005. The tax aims at redistributing mineral rents to poorer regions, indigenous peoples, agricultural communities, universities and other public institutions. Resources are invested in education, health, infrastructure and productive activities that lead to the generation of employment.

The financing of Renta Dignidad was not among the original uses of the tax, and it provoked strong resistance from entities that would see their share of the tax revenue reduced, especially in regions governed by the opposition to President Evo Morales's party. First payments began in February 2008, amid strong support from the pensioners' federation, peasant organizations and other social groups, with claimants totalling 676,000 at the end of 2008.⁶⁰ Tensions between the government and the other sectors and groups benefiting from the hydrocarbon tax revenue exploded in August 2008, when it was decided to increase the annual amount of the pension due to high international gas prices. Thus, while Renta Dignidad has gained the status of an acquired right, at least among its recipients, the way towards progressive improvements and extensions of the scheme is still subject to negotiations among different actors and development priorities competing for the use of mineral rents, and will ultimately depend upon the volume of these rents. In this sense, recent declines in exports (in March 2009 export levels were 25 per cent less than for the same month in 2008⁶¹) and in prices of natural gas (a 42 per cent decline between January and early April 2009) due to falling demand highlight the risks associated with financing Bolivia's social pension, and social policies in general, with highly volatile resources.

Overall, it is reasonable to posit that successful management of mineral rents is a demanding task, especially for developing countries with weak political and economic contexts and where distributional struggles and inequality loom large. In spite of tremendous social needs, the capacity of low-income countries to absorb funds without

causing macroeconomic instability is often limited, which calls for a cautious approach in terms of the fiscal and monetary management of these flows. The contrasting examples of Norway and Bolivia show that it is crucial to construct a social consensus about the use of mineral rents for development.

The contrasting examples of Norway and Bolivia show that it is crucial to construct a social consensus about the use of mineral rents for development

Aid can contribute to social development and international justice

When identifying possible financing sources for development, taxation and aid are often juxtaposed against each other due to their different effects on economic and political systems. Yet external funding through international development cooperation remains an important pillar of development finance. International donors have agreed to substantially increase ODA for low-income countries in order to accelerate the MDG process. And, although development assistance in the past has shown a procyclical pattern with regard to global economic boom and bust cycles, donors have promised to maintain ODA levels despite the recent economic crisis.

The upsides and downsides of aid

Additional funding for poor countries can ease financial constraints. But, like rents from natural resources, aid flows are volatile (see box 8.3), tend to parallel global and national economic trends, and pose a variety of political and economic challenges. These challenges are related to conditionality, accountability and the effects of Dutch disease (see box 8.2), which have to be addressed successfully in order to make aid more effective for development.

BOX 8.3: Aid – Good intentions are slow to materialize

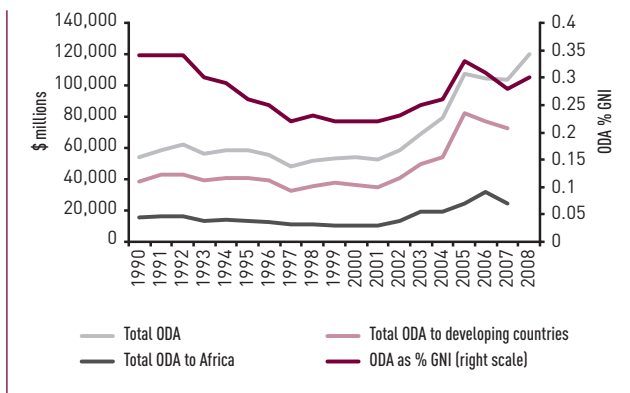
Despite rich countries' recurring commitments to provide 0.7 per cent of their gross national product to official development assistance, total ODA from OECD donors as a percentage of their combined gross national incomes consistently falls below this target (see figure 8.5). In absolute numbers, ODA has been on the rise since the 2000s. It peaked between 2005 and 2006 due to large Paris Club debt-relief operations for Iraq and Nigeria, and special humanitarian assistance provided for the Indian Ocean tsunami and earthquake in Pakistan.^a After a slight decrease between 2006 and 2007, aid reached \$119.8 billion in 2008, the highest dollar figure ever recorded.^b However, as a proportion of gross national incomes, aid flows have been decreasing since 2006.

The volatility of aid flows is increased by geopolitics, which tends to play a decisive role in the global redistribution of funds. Post-conflict countries, such as Afghanistan, the Democratic Republic of the Congo and Iraq, accounted for over 60 per cent of the total ODA increase between 2001 and 2004. Estimations of the volume of aid needed to help developing countries cope with the global economic crisis and achieve the MDGs have included the proposal to dedicate 0.7 per cent of rich countries' stimulus packages (about \$15 billion) to a vulnerability fund for the poorest developing countries^d and to raise \$1 trillion in aid.^e A portion of these funds will be needed to help developing countries classified as highly indebted cope with debt distress brought about by the crisis, as growth rates and export earnings fall and shifts in exchange rates affect repayment ability.^f

Though aid has recently picked up (see figure 8.5), future trends may not be promising. Indeed, the global economic crisis could well lead to cutbacks in aid budgets as advanced industrialized countries strive to deal with growing domestic fiscal deficits and take up huge financial commitments to rescue their domestic markets.^g In addition, recent injections of resources into multilateral agencies, such as the IMF, the World Bank and the regional banks, are shifting the composition of assistance flows towards loan facilities rather than development aid strictly interpreted (based on non-refundable grants). At the same time, UN agencies are not being allocated additional funds. Despite the recapitalization and creation of new financing facilities within the Bretton Woods institutions, there is a danger that these new funds will largely bypass the poorer, most vulnerable countries and instead be directed mainly towards emerging markets and middle-income countries.^h Indeed, substantial reforms of the IMF's and World Bank's loan design and governance mechanisms, which currently exclude developing countries, are being increasingly advocated in order to ensure that policy recommendations and conditionalities attached to the loans promote countercyclical policies, protect social spending and target poverty reduction.

Besides bilateral and multilateral aid, new international sources of development finance are emerging. Some of these, such as global funds and special drawing rights, already exist; others have been proposed or introduced only recently, such as luxury taxes, currency transaction taxes or taxes on activities with a negative environmental impact, such as air flights.ⁱ In addition, South-South transfers are becoming increasingly important as a means of international redistribution, including ODA by Southern donors (China or Venezuela), regional integration initiatives and South-South banks.^j

Notes: ^a OECD-DAC 2009b. ^b OECD-DAC 2009c. ^c CSDH 2008. ^d ODI 2009. ^e Birdsall 2009. ^f Mold et al. 2009. ^g Mold et al. 2009. ^h Mold et al. 2009. ⁱ Atkinson 2005. ^j Ortiz 2009.

FIGURE 8.5: Official development assistance, 1990–2008

Source: UNRISD elaboration based on data from OECD–DAC 2009a.

Aid can contribute to poverty reduction and have a positive impact on social sector spending. A recent study⁶² that measured changes in government social spending on health, education and sanitation as a function of variations in aid flows, tax revenue as a share of GDP, and per capita GDP over a given period shows that foreign aid, on average, has a small but significant effect on government social spending (1.7 per cent increase for every 10 per cent increase in aid). However, the effect of increases in tax revenue on government and social spending is found to be significantly larger, at 3.2 per cent.

Aid has a greater impact on social spending in low-income countries than in middle-income countries. This is not only because middle-income countries tend to spend more, on average, on social services regardless of aid or tax revenues, but also because aid to middle-income countries is more likely to go towards investments in infrastructure.

Aid has a small but significant effect on public social spending; the effect of increases in tax revenue is significantly larger

Besides influencing government social spending, aid also affects measures of aggregate welfare – either directly, by creating income-earning opportunities and providing services, or indirectly, by contributing to growth.⁶³ Finally, there is robust evidence that aid does indeed finance government social spending to reduce poverty and improve human welfare. Still, government social spending is less likely to have an impact on aggregate welfare in low-income countries. One reason is the low quality of public services generally, and consistently low levels of social spending. Positive effects of aid increases will be enhanced if backed up by measures to improve state capacity, especially in terms of allocating funds and delivering services (see chapter 10).

Perhaps the most striking aspect of the current global economy is the net transfer of financial resources from poor countries to rich countries

Finally, aid is important not only in terms of financing social expenditure (and pro-poor economic infrastructure) in recipient countries, but also as an element of international justice. Enormous global wealth disparities – half the world's population have access to just 1 per cent of the world's assets – give rise to debates about international redistribution.

Perhaps the most striking aspect of the current global economy is the net transfer of financial resources from poor countries to rich countries (see table 8.4). Overall, debt interest payments, investment profit remittances, and the portfolio of central bank reserves offset net financial inflows to developing countries. Rich countries, most notably the United States, are at the receiving end of the vast majority of global savings, which has been identified as one of the main causal factors of the global economic crisis.

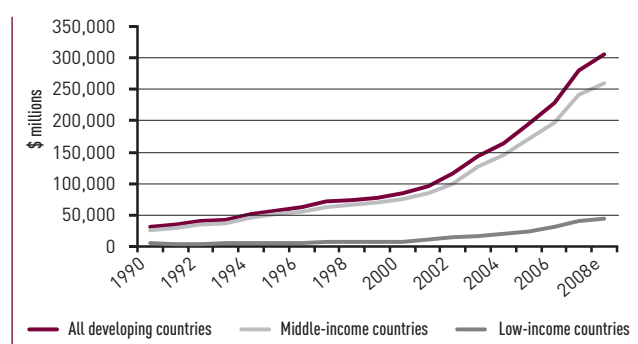
TABLE 8.4: Net financial transfers to developing countries (\$billions)

Year	1996	1998	2000	2002	2004	2006	2008
Africa	-8.4	13.0	-31.4	-5.1	-36.4	-78.8	-125.9
Sub-Saharan Africa (excluding Nigeria and South Africa)	5.2	11.9	3.0	4.5	2.5	-8.4	-28.6
East and South Asia	18.9	-128	-119.8	-145	-177.7	-375.2	-431.9
Western Asia	10.6	34.2	-31.4	-19.7	-70.7	-158.0	-315.6
Latin America and the Caribbean	-0.5	43.1	-2.8	-30.4	-80.6	-108.8	-60.0
Transition economies	-8.7	0.7	-51.5	-28.6	-63.3	-124.6	-171.2
Highly indebted poor countries	6.7	8.5	8.2	12.4	12.8	12.8	26.1
Least developed countries	11.5	13.5	6.6	9.6	8.1	-5.4	-22.3

Source: UNRISD elaboration, based on data from UNDESA (2009b).

Remittances are a financing source for development and household welfare

If social insurance and pension funds have a clear and direct link to social policy, remittances arguably stand at the opposite end of the spectrum. Nevertheless, in a context where global capital flows are increasingly volatile and aid commitments lagging, the steady growth of global remittance flows has generated optimism in policy circles (see figure 8.6).

FIGURE 8.6: Annual remittance flows to developing countries

Note: e = estimate. Source: UNRISD elaboration with World Bank staff estimates, based on IMF data (World Bank 2009b).

Remittances are seen as stable, countercyclical development finance from below, providing foreign exchange at the macro level and increasing income, consumption and investment for receiving households at the micro level. Yet the positive effects of remittances are countered by problems associated with migration, including brain and care drain, social disintegration and remittance dependency, as well as the effects of Dutch disease (see box 8.2). Moreover, the countercyclical nature of remittances does not hold once home and destination countries are exposed to similar external shocks, such as the global economic crisis. Questions therefore arise as to the impact remittances have on the different dimensions of social development, how they shape patterns of social provisioning and the implications for social policy.

What has been observed is that remittances are more important when public social protection programmes are less developed and welfare provision is largely informal. Guatemala and Haiti are two low-income countries following a service-led development path, with agriculture remaining important in terms of employment and livelihoods. Remittance expenditure patterns in these two countries show that households spend a considerable portion of

transfers from abroad on social services such as health and education. In Guatemala, for example, households receiving remittances use them to finance more than half of their expenditures on health and education.⁶⁴ However, the impact on out-of-pocket payments (or insurance contributions) is not the only link between remittances and social protection. UNRISD research reveals that remittances can lead to higher tax receipts, which, in turn, contribute to the financing of public policies.⁶⁵

In Guatemala, households receiving remittances use them to finance more than half of their expenditures on health and education

International migration generated \$5.5 billion in remittances for Viet Nam in 2005, a figure nearly equal to combined ODA (\$3 billion) and foreign direct investment (FDI) (\$3 billion) that year.⁶⁶ Besides revenues sent by migrant workers abroad, internal migration, mainly from the countryside to urban and industrial areas, accounted for 80 per cent of the transfers received and reported by Vietnamese households in 2002.⁶⁷ Remittances in Viet Nam are considered crucial for reducing poverty and sustaining livelihoods.

Nevertheless, in the context of the global economic crisis, remittance flows have decreased considerably (the World Bank estimates a global decline of 5–8 per cent in 2009),⁶⁸ exposing the risks associated with heavy reliance on a development model based on migration. Admittedly, remittances produce an increase in migrant households' monetary income, which can then be spent for different purposes, including social protection and community projects. However, it is also generally agreed that remittances, like any other form of private revenue, cannot substitute for public social policy. They can merely serve to complement it.

4. Financing Social Development: Implications for Policy

UNRISD research has shown that social policies cannot be divorced from the financing structures that underpin them. Affordability arguments effectively foreclose discussions about the possibility of expanding and diversifying the existing resource base. Research and policy makers must begin to explore the complex challenges of mobilizing resources in a way that not only increases fiscal space for social policies, but also reinforces it. The quality (and not simply the quantity) of fiscal resources is important for creating and strengthening synergistic feedback with social policy systems.

Create financing mechanisms that are sustainable, equitable and conducive to economic development

Ideally, revenue and expenditure policies for social provisioning should respond to the principles of efficiency, equity and democratic accountability. They should be embedded in and support a broader macroeconomic framework that is conducive to productive investment and employment. In a nutshell, the challenge is to build social programmes based on financial arrangements that are themselves sustainable in fiscal and political terms, equitable and conducive to economic development. This chapter has argued that domestic financing instruments, such as taxation and social insurance, if well designed, are best suited to create these synergies, to strengthen democracy and social solidarity, to support a social contract among citizens and with their political leaders, and to provide the latter with more policy space. Private and external resources (including mineral rents), although second best from an economic and equity point of view, have the potential to complement public domestic financing.

Although no clear-cut links can be found between specific growth patterns, policy regimes and revenue sources,

high-tax (including social contributions) regimes are more frequently found in countries following the manufacturing-led growth path. These include East Asian developmental states, former socialist countries in Eastern Europe and Central Asia and some dualistic states, such as Brazil and South Africa. Tax shares are usually lower in countries following growth paths led by services, mineral rents or agriculture.

The composition of revenues is strongly determined by a country's level of development and prevailing economic structures, in particular labour market characteristics. Economies characterized by high proportions of informality do not perform well in terms of taxation, especially direct taxes, and few people contribute to social insurance schemes. Therefore, these countries rely heavily on the more regressive forms of consumption taxes and user fees to finance social protection and social services. External resources such as aid, remittances or resource rents often fill in the gaps, but they are also bedevilled with problems of volatility, conditionality and adverse effects on macroeconomic stability.

Consider the political and macroeconomic effects of various types of financing

Whether improved funding opportunities eventually increase social expenditures, are channelled into productive investment, pile up in central bank reserves, or reduce public debt (not to mention corruption and other types of illegal appropriation of public funds) is a political decision. The more democratic, accountable and transparent the political process is, the more likely social programmes and the corresponding budget allocations will reflect the public interest and a reasonable balance between transfers and investment, economic and social spending. As mentioned earlier, some countries have started to experiment with alternative budget processes in order to improve budget analysis and outcomes of fiscal policy for local communities or specific groups, such as women. The results are encouraging.⁶⁹

The way in which social expenditure is financed is not neutral in its distributional or productive effects. Reforms entail potential losers and winners, which may or may not correspond to groups benefiting from public transfer schemes and social investments. The macroeconomic effects of different financing sources, such as the impact on domestic demand, investment and savings, monetary stability and currency risks, have to be considered carefully.⁷⁰ Similarly, the implementation of progressive direct taxes on wealth and income tends to create opposition from influential social groups and can lead to reform blockades. Therefore, the more universal social programmes are, the easier it is to find convincing arguments for progressive funding structures, which are built on relatively greater contributions from higher income groups.

The more universal social programmes are, the easier it is to find convincing arguments for progressive funding structures

Anchor a country's social policy system with domestic sources of financing

Like the budget process, financing structures are inherently political. The source of funding has profound implications for the political economy of building and sustaining social policies. External sources of funding, in particular ODA, are only sustainable as long as donor commitments last. Internal sources, on the other hand, if designed effectively, have the potential to create intergenerational and interclass linkages that are more difficult to break over the long term. These domestic financing structures are the core or the anchor of social policy systems. Domestic financing instruments are levied on national economic activity and they redistribute among different groups. Macroeconomic policies that foster income creation and decent, formal employment are therefore the foundation for any successful fiscal strategy.

Notes

- 1 Di John 2008; United Nations Millennium Project 2005.
- 2 De Haan 2007; Besley et al. 2003.
- 3 Figures for 2003, regional averages for 2004 (OECD 2007).
- 4 De Haan 2007; Melo 2008.
- 5 Hicks and Wodon 2001.
- 6 Kwon 2005; Bird 2008; Vos et al. 2008.
- 7 Delamonica and Mehrotra 2009.
- 8 Delamonica and Mehrotra 2009.
- 9 Grown and Valodia 2010.
- 10 Huber 2006; Barnett and Grown 2004.
- 11 De Haas (forthcoming).
- 12 De Haas (forthcoming).
- 13 Manow 2001; Estevez-Abe et al. 1999.
- 14 Funding instruments, such as microcredit or other financial sector instruments (including domestic savings), public debt financing, as well as resource mobilization via debt relief for the poorest countries (HIPC initiative), are definitely important, but will not be discussed here (see UNRISD 2000; Vos et al. 2008; United Nations 2008b). See also chapter 10 of this report.
- 15 United Nations 2008b.
- 16 Vos et al. 2008.
- 17 Moore 2004; Fjeldstad and Rakner 2003; Bräutigam et al. 2008.
- 18 Di John 2008.
- 19 Gupta et al. 2005; Glenday 2006; Aizenman and Jinjark 2006, cited in Sindzingre 2009.
- 20 See Jiménez and Gómez Sabaini (2009) for Latin America.
- 21 Sindzingre 2009; Di John 2008.
- 22 Lue 2008.
- 23 Haggard and Kaufman 2004.
- 24 ECLAC 2006.
- 25 Barrientos 2008.
- 26 Schneider and Baquero 2006.
- 27 Seekings and Natrass 2008.
- 28 Seekings and Natrass 2008.
- 29 Poirson 2006.
- 30 Dietsche 2008.
- 31 Mkandawire 1995.
- 32 Riesco 2008.
- 33 Riesco et al. 2005; Guajardo 2007.
- 34 Guajardo 2009.
- 35 Di John 2008.
- 36 Delamonica and Mehrotra 2009.
- 37 Cobham 2005.
- 38 Kwon 2005.
- 39 Seekings and Natrass 2008; Mesa-Lago 2009a.
- 40 Kangas 2009.
- 41 Asher 2009.
- 42 Kangas 2009.
- 43 Müller 2003.
- 44 World Bank 1994; Charlton and McKinnon 2001; Hujo 2004; Arenas de Mesa and Mesa-Lago 2006.
- 45 World Bank 1994, 2001b.
- 46 AIOS 2008.
- 47 AIOS 2008.
- 48 Titelman et al. 2009.
- 49 Titleman et al. 2009.
- 50 Mesa-Lago 2009b.
- 51 Lo Vuolo 2008; Mesa-Lago 2009b.
- 52 Rostow 1960.
- 53 Sachs and Warner 1995; Auty 2001; Collier and Hoeffler 2005.
- 54 Stürmer 2008.
- 55 Mehlum et al. 2009; BBC News 2009.
- 56 Holmøy 2009.
- 57 Holmøy 2009; Mehlum et al. 2009.
- 58 Mehlum et al. 2009.
- 59 Müller 2009.
- 60 HelpAge International 2009.
- 61 Revenue Watch Institute 2009.
- 62 Morrissey 2009.
- 63 Morrissey 2009.
- 64 Orozco 2009.
- 65 Orozco 2009.
- 66 Dinh 2008.
- 67 Dinh 2008.
- 68 Ratha and Mohapatra 2009.
- 69 Bloj 2009.
- 70 Vos et al. 2008.