Financing Social Protection

Working Paper

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I. Abstract

The paper provides a definition of financing, describes task and objective of financing, sources of financing, asks the question what to finance. It discusses the political importance of financing and discusses advantages and disadvantages of contributory and non-contributory schemes. It discusses funding versus pay as you go financing modalities. It analyses function and kind of subsidies. It defines fiscal space and discusses how to create and calculate it. It discusses political aspects and disadvantages and disadvantages if financing by loans. Finally, it shows administrative challenges of financing.

Thus, the paper developes step by step all aspects related to financing. Financing is one of the main tasks when establishing and designing social protection systems. Development policy has always a lot of links to financing and its elements. The chapter shows, that sound financing constitutes one of the key elements of all development strategies and policies.

II. Definition of Financing

Financing is "The act or process or an instance of raising or providing funds."[1] The next chapter will show that the concept of financing can be broader in the sense that financing may fulfil various tasks, not just providing funds.

Also, financing includes activities like investment, has managerial aspects and may be split into categories. "Finance is a field that is concerned with the allocation (investment) of assets and liabilities over space and time, often under conditions of risk or uncertainty. Finance can also be defined as the art of money management. Participants in the market aim to price assets based on their risk level, fundamental value, and their expected rate of return. Finance can be split into three sub-categories: public finance, corporate finance and personal finance".[2]

Financing of social protection development is a narrower field of public finance as it is linked to the question how to develop social protection, and which role "the art of financing" plays in this development.

III. Task and objective of financing

A. *Creation of resources*

One of the main tasks of financing activities is the mobilization of resources in order to be able to redistribute resources (see later in this chapter) and to fulfil, for example the tasks of social protection development. Ways to mobilize resources will also be

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[1] Merriam Webster Dictionary "Finance". https://www.merriam-webster.com/dictionary, retrieved on Dec. 4, 2019

[2] Investopedia (2003-11-20). "Finance". *Investopedia*. Retrieved on Nov.11, 2019

discussed later in this paper. They include contributions, taxes, donations, co-payments, loans and profits. Resources are used to pay for benefits. These benefits can be linked to contribution payments made or may be non-contributory. A social insurance pension, for example, in most cases is based on payments made. Social assistance or social pensions are based on needs, not on payments made. Both kinds of benefits depend on resources that have to be collected. Different types of financing thus are not only characterized by the way of mobilizing the resources, they also determine kind and level of benefits.

B. Influencing behaviour

Taxing influences behaviour. The way of financing can influence behaviour by sanctioning certain behaviour or rewarding it. If for example the consumption of alcohol or tobacco is taxed, this may reduce consumption. Taxes thus can make certain products or services more expensive and thus influence consumption of these.

On the other hand, tax reductions may encourage behaviour. An example may be tax deduction of costs of using public transport commuting to the workplace.

It is an old discussion whether in times when technology replaces labour through machines it is useful to make labour more expensive by assessing contributions based on wages. An alternative would be to tax machines instead of labour and thus influence employment patterns[3]. To tax machines may mean to tax added value instead of labour input.

C. Redistribution

Redistribution[4] of income and wealth means the transfer of income and of wealth from some individuals to others by mechanism such as "taxation, charity, welfare transfers, public services, land reform, monetary policies, confiscation, divorce or tort law"[5].

Financing can be used to increase equity and equality and improve social protection through redistribution. Redistribution can be defined as average contribution or tax payment of one group in order to finance receipts or benefits of another group.

Redistribution is closely linked to affordability, financial capacity, poverty reduction, equity and justice. Any system of resource mobilization on one hand and budget spending on the other hand can be used for redistribution, which in the end is a policy instrument.

Redistribution is an inherent policy outcome of any social protection system and basically is implemented through financing systems. Technical instruments are income related contributions, progressive tax systems, contributory and non-contributory benefits like social assistance.

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[3] https://www.theguardian.com/business/2017/mar/22/robots-tax-bill-gates-income-inequality, retrieved on Dec. 3, 2019.

[4] See also https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-Fokus-Volkswirtschaft/Fokus-englische-Dateien/Fokus-Nr.-110-November-2015-Which-factors-influence-redistribution.pdf. Retrieved on Dec. 3, 2019.

[5] *Stanford Encyclopedia of Philosophy*. https://plato.stanford.edu/entries/redistribution/ retrieved on 11.14.2019

Redistribution also is an inherent element of any insurance system, where there are financial shifts between persons with and without risk-based damages. This is called risk pooling[6].

Thus, redistribution may have a political, a social, or risk pooling motivation.

IV. Possible sources of financing

A. Contributions

In general, a contribution is "something that you contribute or do to help produce or achieve something together with other people, or to help make something successful"[7]. In social protection a contribution is paid into a pool, either to earn the right to later benefit payment or in order to participate in risk pooling. Contributions have the advantage that they normally are earmarked for a specific purpose and not part of general budget. They constitute extra budgetary revenue. Also, they give contributors the feeling that their payments entail particular benefits and thus increase acceptance.

Contributions can have various forms, which all have different impacts on distribution and affordability. They may be a percentage of income, a flat rate, risk related or scaled. The disadvantage of contributions is the extra effort in collecting them, and thus they cause more administrative costs than benefits paid from general budget. They may be compulsory or voluntary, which may have different impacts in terms of risk selection. Contribution financing also is often used in cases where only a part of the population is covered by a social transfer system.

B. Taxes

"Taxes are involuntary fees levied on individuals or corporations and enforced by a government entity — whether local, regional or national — in order to finance government activities"[8]. Taxes are compulsory payments in order to finance the public expenses. Generally, taxes may be divided in direct taxes like income tax and indirect taxes like VAT. Main kinds of indirect taxes are consumption taxes (such as VAT) and main kinds of direct taxes are personal and corporate income and assets tax. Taxes can be levied on various levels of state: federal, province and community level. A social protection system may be entirely or partly financed by taxes. Like contributions, taxes require a collection and monitoring system.

Funding social protection through taxes has two advantages: only one national collection mechanism is needed, and at least income tax is based on affordability. In developing countries, tax systems, however, often are either inefficient or they have to deal with large informal sectors, which are often impossible to tax.

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[6] http://siteresources.worldbank.org/INTHSD/Resources/topics/Health-Financing/HFRChap3.pdf, retrieved on Dec. 3, 2019

[7] https://dictionary.cambridge.org/de/worterbuch/englisch/contribution, retrieved on November 27, 2019

[8] https://www.investopedia.com/terms/t/taxes.asp, retrieved on Nov. 30, 2019

C. Subsidies

"A subsidy is a benefit given to an individual, business, or institution, usually by the government. It is usually in the form of a cash payment or a tax reduction. The subsidy is typically given to remove some type of burden, and it is often considered to be in the overall interest of the public, given to promote a social good or an economic policy"[9]. Subsidies are payments from public budgets or from the private sector to support certain activities, or semi-public or private budgets.

In social protection, subsidies are common in order to cover expenses or to achieve certain political objectives. Subsidies may be paid only once or regularly, for example yearly. They may be linked to certain determinants like demography or certain groups like the poor. They can be used to finance infrastructure (e.g. hospitals) or minimum benefits. In the last years, subsidies have become common to co-finance health insurance and minimum pensions for the poor. They may be means tested or not.

A special form of subsidies is so called „hidden subsidies ", which may be given through discounts on prices and contributions.

D. Loans

Loans constitute a means to finance public expenditure. Loans may be taken from private sector or from international development partners, and financial institutions, for example. They spread financial burdens over a more or less long period and have a price: interest payments.

Politically, loans have an important function. They allow Ministries to add extra programs or expenses to public budget without cutting the budget of other ministries or collecting higher taxes. So, they can slowly, step by step, establish a new budget line. The disadvantage of loans is that the repayment and the interest payments bind parts of the public budget and thus reduce financial flexibility.

For social protection, loans make sense when building up schemes in order to finance infrastructure and capacity building for example. They normally are not useful to pay for benefits, as this is not sustainable.

E. Development aid

Development aid is „expended in a manner that is anticipated to promote development, whether achieved through economic growth or other means[10]". It may consist of grants or concessional loans. Both are meant to finance infrastructure, capacity building, studies, start-up system development, design concepts etc. Development aid is provided by international and national development banks, national and international aid organizations, NGOs, private and public firms and Governments. Development aid may constitute a major part of the income of national social protection schemes. In many developing countries, social protection coverage would – at least initially - not exist without foreign aid. Start-up and follow-up operation of social protection schemes mostly is supported by grants and less by loans.

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[9] https://www.investopedia.com/terms/s/subsidy.asp, retrieved on Nov. 30, 2019

[10] Minoiu, C., & Reddy, S. (2009). Development Aid and Economic Growth: A Positive Long-Run Relation Retrieved from https://www.imf.org/external/pubs/ft/wp/2009/wp09118.pdf

F. Prices, fees and profits

Social protection schemes may operate own health facilities or may provide other services that are paid, for example legal advice, complementary cover etc. Penalty fees may also be charged for late payment of contributions. Handling fees may be charged for administrative services. The income earned by these facilities and services also may constitute a source of financing for the schemes.

Social protection schemes may also hold shares of private companies, which generate profits.

G. Co-payments

„Payment required of an insured person for that portion of medical expenses not paid by the insurance company; specif., a fixed fee required for each prescription, visit to a doctor, etc. ".[11] Co-payments are an instrument widely used in health schemes. They constitute an official form of out-of-pocket payments. They may be described as cost-sharing, where part of the costs of health products and services is paid directly by the patient. The share of co-payments may be high or negligible, depending on the financial situation of the health scheme. Co-payment may be a percentage of the price or fee, a fixed amount, may have the form of top-up payments, if reimbursement of the health system has a maximum limit called "cap". It may as well be combined with stop-loss arrangements, which basically cap the total amount of co-payments over the year. Co-payment may be conflicting with the individual ability to pay. In any case, they may constitute a major part of the financial sources of a health scheme.

V. What to finance?

A. Priorities in benefit packages

If we ask what to finance, benefit packages are key. Especially when building up a social protection scheme, the right size and composition of benefit packages are of high importance. Basically, the core question is that of the justification for resource mobilization (contribution payment or taxes). Benefit packages have to be designed for health schemes, pension schemes, invalidity schemes and cash transfer schemes alike. Parameters that have to be decided are levels of payment/reimbursement, formulas, replacement rates, eligibility, and beneficiaries. There may be different priorities in developing countries and more developed countries, especially when starting up a scheme. This includes the question, with which branch of social protection to start. Most countries start their social protection schemes with health and cash transfer (conditional or non-conditional) schemes.

B. Administration

Administration normally is the smaller part of what has to be financed. The share of total budget that has to be dedicated to administration depends on relative costs of human resources, relative costs of IT, and the degree of complication of administrative tasks. If, for example, contribution collection requires high administrative efforts or enforcement of compliance is difficult, costs of administration may be relatively high. In total, administration may account to up to 20% of total expenditure. However, it

[11] https://www.collinsdictionary.com/de/worterbuch/englisch/co-payment, retrieved on Nov. 30, 2019

may depend on the size and the maturity of the scheme. Small and young schemes tend to absorb larger parts of total budget for administration due to low economies of scale.

VI. Political importance of financing

Financing social protection plays an important political role in a political system. In a democratic system the burden of social protection financing may significantly influence elections. People tend to sanction higher financial burdens as well as lower benefits, not acknowledging the linkage between both. Thus, the financial burden as well as the level of benefits are politically important. In this context it has to be taken into account that there are various ways of financing, which have different effects on the „felt" burden for contribution payers. For example, financing through indirect taxes is less feel-able than financing through direct taxes. Sharing contributions between employers and employees is less feel-able than putting the whole burden directly on the insured, though the distributive effects may be the same, as employer contributions have to be regarded as part of the total salary package or labour cost.

Politically of special importance are questions of redistribution and affordability, which both may face political resistance.

VII. Contributory or non-contributory?

A. Earmarked funding versus administrative savings

One of the key questions when conceptualizing a scheme is that of contributory or non-contributory. The clear advantage of contributory schemes is the earmarked funding. Funds collected are clearly separated and reserved for social protection purposes. The advantage of tax financing on the other hand is that only one public collection mechanism is needed. Thus, administratively, non-contributory schemes are generally cheaper.

B. The issue of affordability

The question of affordability emerges most transparently in contributory schemes, especially if benefits are clearly linked to prior contribution payments. This is why more and more health and pension schemes introduce free benefits for the poor, whether with or without means test. The Philippine Health Insurance for example provides free health care with means test for the poor. Nepal has a universal pension scheme without means test.

C. Equity and Financing

If the target is equitable financing, both, contributory and non-contributory schemes have advantages. Non-contributory schemes are clearly more equitable with regard to the poor. Contributory schemes are more equitable with regard to those who can pay.

D. The Objective

Some schemes like universal or means-tested cash transfers are non-contributory by their intention. They are meant as tool for poverty reduction. On the other hand, if the objective of a scheme is risk-coping, contributions and risk pooling may be appropriate way to improve social protection.

E. Coverage and Formality

If universal coverage is the main objective in a country, contributory schemes have a disadvantage with regard to informal sectors. It is often very difficult if not impossible to formalize informal sectors in order to install a contribution financing. A special problem is equity and affordability because only flat amount contributions are technically realistic and feasible. These on the other hand are degressive. This is why especially developing countries aim at non-contributory coverage of the poor, when aiming at universal coverage.

F. The attribution of benefits

1. Benefits linked to contributions

Benefits that are conditional on contributions, are provided only if prior contributions were paid (in kind benefits, e.g. health). Benefits that are linked to contributions have amounts that depend on of prior contributions paid (i.e. in the case of cash benefits, such as pensions). To provide benefits based on the levels of contributions requires sophisticated formulas, recording systems and checks. The advantage is that they reflect incomes and payments made. The disadvantage is that they may be very low (in case of cash benefits) and they exclude those for whom contributions were not affordable (in kind benefits). Universal coverage is difficult to obtain through contributory systems.

To provide in-kind benefits conditional on contributions requires checks of contributions paid when availing of benefits.

2. Benefits that are not dependent on prior payments

These benefits normally have the form of standard packages provided to everyone without further check (in kind benefits) or of standard flat amounts (cash benefits) for example social pensions like the one in Nepal, or cash benefits like the one in Mexico. Administratively these benefits are easier to handle if not combined with a means test.

The advantage of these benefits is that universal coverage is easier to obtain. The disadvantage is the uniformity (cash benefits), which does not reflect careers and effort during lifetime.

VIII. Funding or pay as you go?

A. Health

In health, pay as you go (PAYG) schemes are nearly standard in social protection schemes around the world i.e. current benefits are paid out of current income. There usually is a risk pool into which people pay and out of which benefits are paid. There is no reserve, maybe except a small liquidity reserve of 2- or 3-months' benefit expenditure.

In some public schemes, but mostly in private and commercial health insurance sometimes reserves are built up in younger ages of the insured, which are used to cushion and reduce the contributions in older ages.

B. Pension

In the pension area there is a long-standing debate about which funding method is better: a capital reserve or PAYG. The argument is that a capital reserves renders a pension scheme immune to demographic change. The PAYG scheme on the other hand is said to be easier to handle, requires no capital market operations and is less sensible to abuse by politicians. In any case, it is easier to switch from a funded scheme to a PAYG scheme than the other way around. The risks PAYG schemes are facing are risks of changes in life expectancy, labour market conditions, salary development and de-facto retirement ages. The risks funded schemes are facing are those posed by uncertainties of capital markets, interest rates, and life expectancies.

We can distinguish defined contribution schemes from defined benefit schemes for both, PAYG and funded schemes. Defined contribution schemes have uncertain benefits, defined benefit schemes work with variable contributions.

C. Invalidity

Invalidity schemes equally may be PAYG or funded schemes, only that other than pension schemes they insure a risk and are in no case of a savings nature. Here also holds true that funded schemes are more difficult to administer than PAYG schemes.

IX. Subsidies

A. As instrument to boost coverage

Public subsidies may be used to boost coverage giving the poor free health care for example or financing a social pension scheme or cash transfers. All this would increase coverage and help to reduce poverty. To boost coverage through subsidies may be combined with a contributory scheme (for example a health insurance) or may subsidize an entire scheme (for example a public health service), which in this case, however, strictly speaking would be no subsidy but rather straight financing from general revenues.

B. To cover deficits

Public subsidies could help to cover deficits of social protection schemes. Deficits may occur either by income from earmarked resources such as contributions falls short or by expenses exceeding certain envisaged benchmarks. These subsidies may be temporary, assisting to achieve a balanced budget in the short run, or may be permanent. Again, subsidies make sense only, if otherwise the scheme has earmarked funding.

C. As compensation

Subsidies may be used to compensate for the financial or administrative burden a Government puts on social protection schemes, which are not part of their original tasks, for example, to oblige a pension scheme to assist in poverty reduction providing minimum pensions or balancing demographic burdens in PAYG schemes (see next para).

D. Subsidies and demography

Subsidies may be used to cushion the effects demography has on social protection schemes, for example on pension or health care. It means to support contribution payers, which may not cover the whole society. If for example 50% of the population are member of a pension scheme, which is struggling with a demographic problem, subsidies will put the burden on more shoulders. On the other hand, it would mean making people contribute through taxes who are not benefitting from the pension scheme, which raises an equity problem.

X. The issue of fiscal space

A. What is fiscal space?

Fiscal space is the financial room that a government has to make its spending choices. More generally, it defines the financial "well-being" of a government. It may also be defined "as room in a government's budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy." [12] Or: "Fiscal space is the financing that is available to government as a result of concrete policy actions for enhancing resource mobilization, and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective, for a specified set of development objectives".[13] The concept of fiscal space is of high political importance for developing countries, as it indicates the existing room for the extension, coverage and quality of social protection. Closely linked to the concept of fiscal space is fiscal or accounting sustainability, which requires not just to aim at balancing present accounts but to also to ensure future financial balances. "For developing and emerging market countries, the issue of fiscal space arises in the immediate term. There is a pressing need for expenditure today, and the challenge is how to find the resources for their financing. The recourse to considerations of fiscal sustainability recognizes that with growth, additional fiscal resources will become available to governments, reflecting the normal buoyancy of revenues, particularly if expenditures rise less rapidly."[14]

B. Creation of fiscal space

To create fiscal space basically means the creation of new hitherto free or the re-orientation of existing resources. This may be done in various ways. „A government can create fiscal space by raising taxes, securing outside grants, cutting lower priority expenditure, borrowing resources (from citizens or foreign lenders), or borrowing from the banking system (and thereby expanding the money supply). But it must do this without compromising macroeconomic stability and fiscal sustainability—making sure that it has the capacity in the short term and the longer term to finance its desired expenditure programs as well as to service its debt."[15] Ways to create fiscal space include: "(i) re-allocating public expenditures, (ii) increasing tax revenues, (iii) lobbying for increased aid and transfers, (iv) tapping into fiscal and foreign exchange reserves, (v)

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[12] Peter Heller: Back to Basics -- Fiscal Space: What It Is and How to Get It https://www.imf.org/external/pubs/ft/fandd/2005/06/basics.htm retrieved on Dec. 1, 2019

[13] Rathin Roy, Antoine Heuty, Emanuel Latouzé: Fiscal Space for What? Analytical Issues from a Human Development Perspective. UNDP Paper for the G-20 Workshop on Fiscal Policy. Istanbul 2007, p. 2

[14] Heller, Peter S.: Understanding Fiscal Space. IMF Policy Discussion Paper, Fiscal Affairs Department, March 2005

[15] Peter Heller: Back to Basics...

borrowing and restructuring existing debt, and/or (vi) adopting a more accommodative macroeconomic framework".[16] Exploiting fiscal space may have risks like inflation, high burden of debt, cutting expenses at the wrong end, etc. Prior to the creation of fiscal space there should be a holistic concept what a government or a society plans to invest in in the longer-term future.

C. Calculation of fiscal space

Fiscal space may be calculated as the difference between an estimated maximum of public debt, beyond which action would have to be taken to avoid default, and actual public debt, expressed as a percentage of GDP or equivalently as the difference between the debt-limit-to-GDP percentage and the actual-debt-to-GDP percentage.[17] [18]

D. The political question of funding through loans

"A loan is money, property, or other material goods given to another party in exchange for future repayment of the loan value or principal amount, along with interest or finance charges. A loan may be for a specific, one-time amount or can be available as an open-ended line of credit up to a specified limit or ceiling amount"[19]. Loans may increase fiscal space and at the same time open new budget lines with less resistance from other budget responsible agencies. On the other hand, loans reduce future financial flexibility. An important question is what to finance through loans. It may not be useful to finance short term projects (except maybe very urgent investments) through long term loans. The benefit from a project ideally spreads over the same period as the costs of the loan. This is why in social protection it is not recommendable to finance benefits through loans. The first reason is that financing benefits should be backed up by a reliable and sustainable funding mechanism like contributions. If benefits are financed through loans in one period, the same funding need emerges in the following periods, and debt quickly accumulates to unsustainable levels.

However, it may be useful to finance infrastructure and capacity building through loans. Both types of investments provide long term benefits and are one-off start-up investments.

Politically it is also an issue from which provider to take the loan. Possible lending institutions are development banks, private banks, or national or international capital market through bonds. Many developing countries take loans from development banks, especially if they are entitled to concessional loans. Reasons why to take loans from certain providers may be: the interest rate, kind and number of safeguards and other

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[16] Ortiz, Isabel; Jingqing Chai; Matthew Cummins: Identifying fiscal space. Options for Social and Economic Development for Children and Poor Households in 182 Countries. UNICEF Social and Economic Policy Working Paper. 2011.

[17] See https://www.economist.com/free-exchange/2015/06/03/how-much-is-too-much. Retrieved on Dec. 1., 2019

[18] How to free and calculate fiscal space for social protection may be seen in: Cichon, Michael: The Social Protection Agenda of the Sustainable Development Goals and Its Fiscal Challenge, in Handayani: Asia's Fiscal Challenge. Financing the Sustainable Development Goals. Asian Development Bank. Manila 2018, p. 10.

[19] https://www.investopedia.com/terms/l/loan.asp, retrieved on Dec. 2. 2019

conditions, the lending period, free project preparatory technical assistance, safety and reliability.

The question, whether to fund through loans, for a country also depends on the total debt situation. Countries that are heavily indebted maybe tend to refrain from loan funding. On the other hand, they may not be able to avail of other sources, for example, in order to set up a social protection scheme (no fiscal space). They may have to recur to grants, if available.

Finally, the debt situation of a Government may be aggravated by implicit debts like pension, health care or long-term care obligations, that may bind future financial space.

XI. Administrative challenges

Resource collection goes along with sometimes serious administrative efforts like: Tax and contribution collection, means testing, income assessment, monitoring and control, to avoid evasion, etc. At the same time, it is necessary to establish public consent and support. So, information campaigns and communication efforts are needed.

XII. Conclusion

Mobilizing sufficient financial resources remains one of the key challenges in development[20]. The chapter developed step by step all aspects related to financing. It became evident that financing is a complex economic, financial, fiscal, strategic and political and hence multi- faceted task. It is one of the main tasks when establishing and designing social protection systems. Development policy has always a lot of links to financing and its elements. Basically, sound financing constitutes one of the key elements of all development strategies and policies.

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