DEVELOPMENT PATHWAYS

Financing social protection investments

Results from CGE simulations

Development Pathways

January 2023

Introduction

Introduction

- Levels of investment in social protection remain relatively low in most low- and middle-income countries
- With competing budget priorities, it is important for national governments to understand the options that are available to finance social protection investments domestically, and which options perform best
- Therefore, it is important to understand how different forms of domestic social protection funding perform comparatively in terms of providing meaningful and transformative economic outcomes
- The study will build on previous research, which applied computable general equilibrium simulations to understand the impact of investing 1 and 2% of GDP with external funding across eight different economies

Background

- Social protection is a human right, which has wide-ranging social and economic benefits for countries at all levels of development
- Current levels of investments are very far from guaranteeing social protection floors, which makes achieving SDG Target 1.3 a distant future
- Among low- and middle-income country, a total of US$1,040 billion or 3.3 per cent of their GDP would have been required to reach universal coverage in 2020

Taxes to finance social protection

- This study focuses on scenarios which increase tax revenue to finance domestically an increase in social protection investments
- Financing social protection through domestic taxation will affect the economy, as rising tax rates will directly affect relative prices in the economy either on goods or production factors (labour or capital)
- Raising taxes is not simple in most countries, as it typically requires significant political capital to approve tax reforms

Approach

Scenarios

- The analysis simulates economy-wide impacts of investing 1% of GDP in social protection across different economies
- In addition to foreign aid, four financing scenarios were considered:
  - Increase income tax progressively
  - Increase corporate tax
  - Increase VAT tax
  - Increase capital tax
- The simulations are performed on eight different economies and structures:
  - Bangladesh, Colombia, Costa Rica, Georgia, Ghana, India, Rwanda and Serbia

Key aspects of the CGE model

- The simulations are based on the the static and dynamic Partnership for Economic Policy standard CGE models, PEP 1-1 and PEP 1-t (Decaluwé et al., 2013a, 2013b)
- In the CGE model, there are four agents: households, firms, government, and the rest of the world
- The model distinguishes between three sources of income: labour (salaries and wages), capital and transfers income
- On the consumption side, households use their income for taxes, transfers to other institutions, consumption, and savings
- Household behaviour is modelled as a Linear Expenditure System (LES) and subject to its budget constraint

Results

Overview

- Financing social protection by increasing taxes do not perform better than financing through foreign aid
- This is not a surprise, as foreign aid does not directly crowd out domestic investments
- There are, however, differing results across the different types of taxes
- While financing social protection through income tax, corporate tax, capital tax can provide some positive small changes in GDP depending on the structure of the economy, financing social protection through indirect taxes generally perform poorly due to large crowding out of investments

Household income

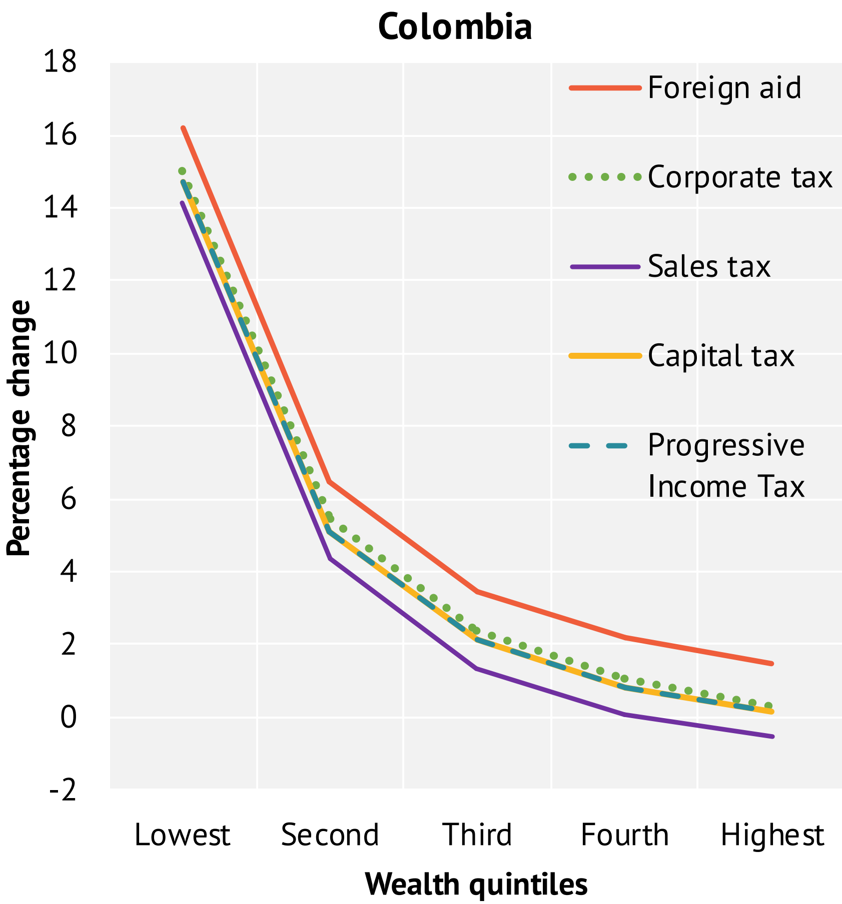
- Across all financing scenarios/countries, poorer households tend to have proportionately better outcomes than richer households, despite the universal disbursement of transfers

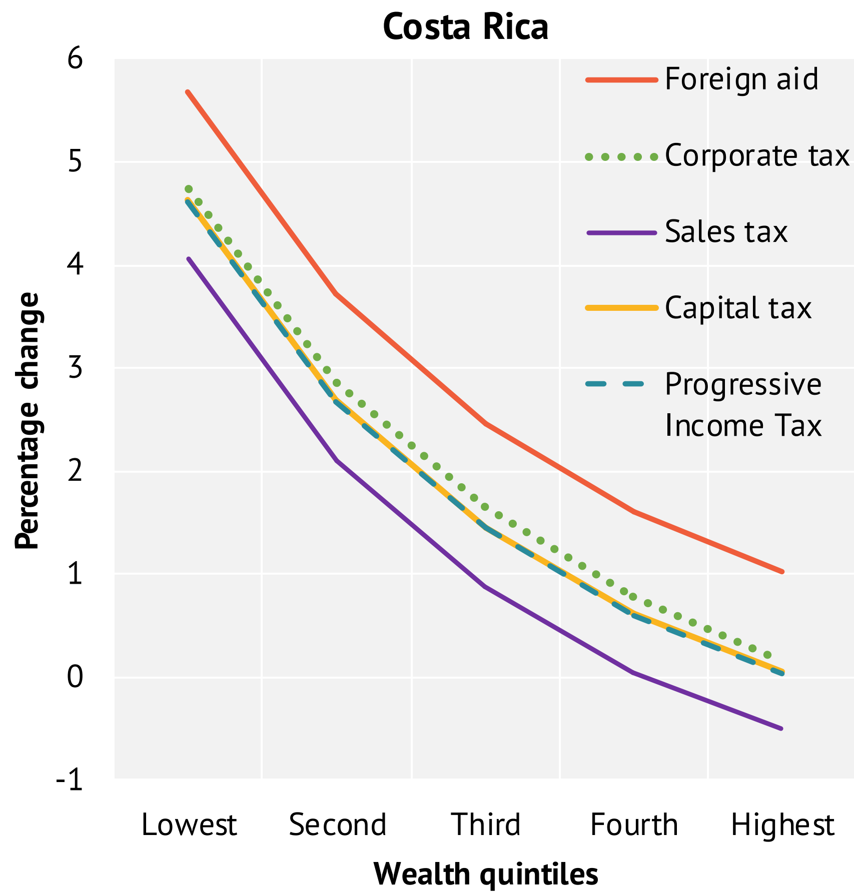
- Domestic financing tends to generate negative changes to the incomes of households in the the top quintiles

- The performance of the different scenarios across countries is linked to existing tax structure, as per the SAM

- Rate at which changes to income decreases across quintiles varies according to the structure of the economy and levels of inequality

Colombia and Costa Rica

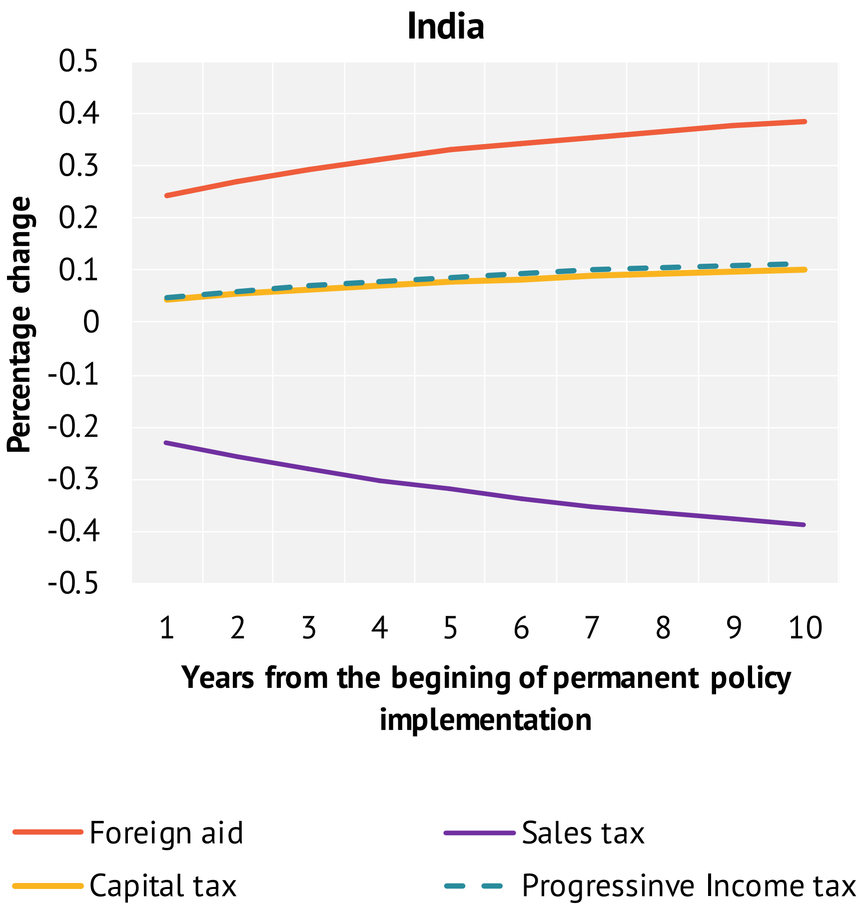


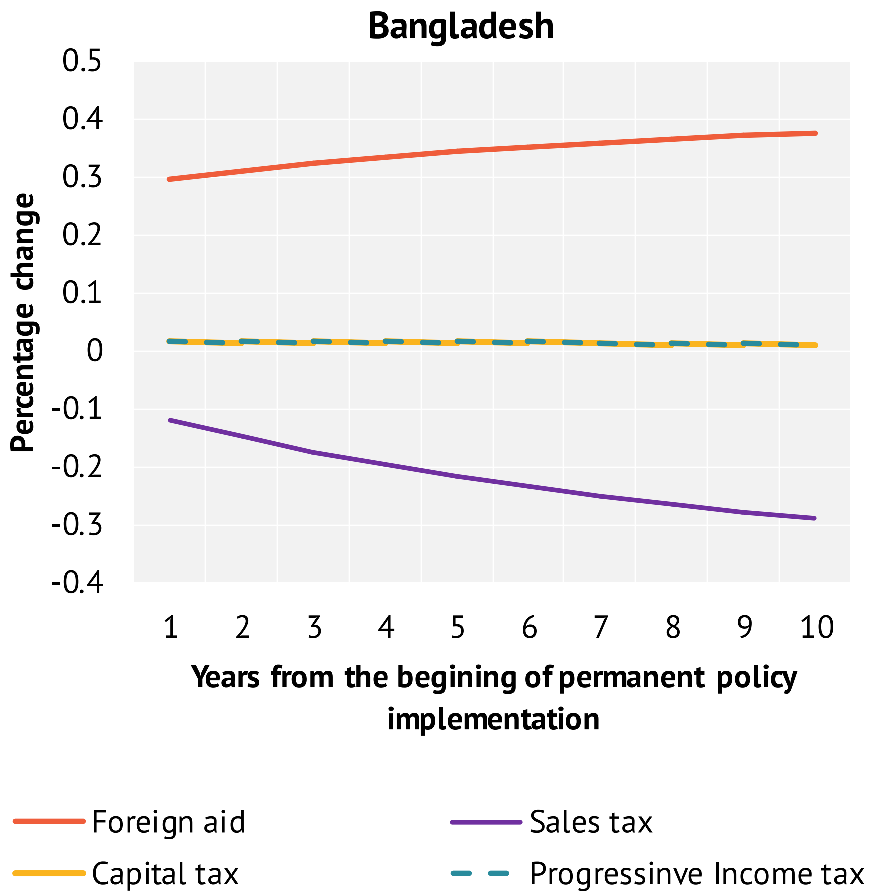


GDP

- Financing social protection transfers through increased income tax revenue mostly produced only modest positive changes to GDP growth rates
- Five out of eight countries had growth under this scenario. Ghana and India, two of the poorest economies, had the most significant positive effects. Financing social protection via higher income taxes seems to reduce GDP levels slightly across Costa Rica, Serbia, and Georgia
- Irrespective of the economy's structure, domestic investments in social protection via VAT have a dramatic negative impact on GDP

India and Bangladesh

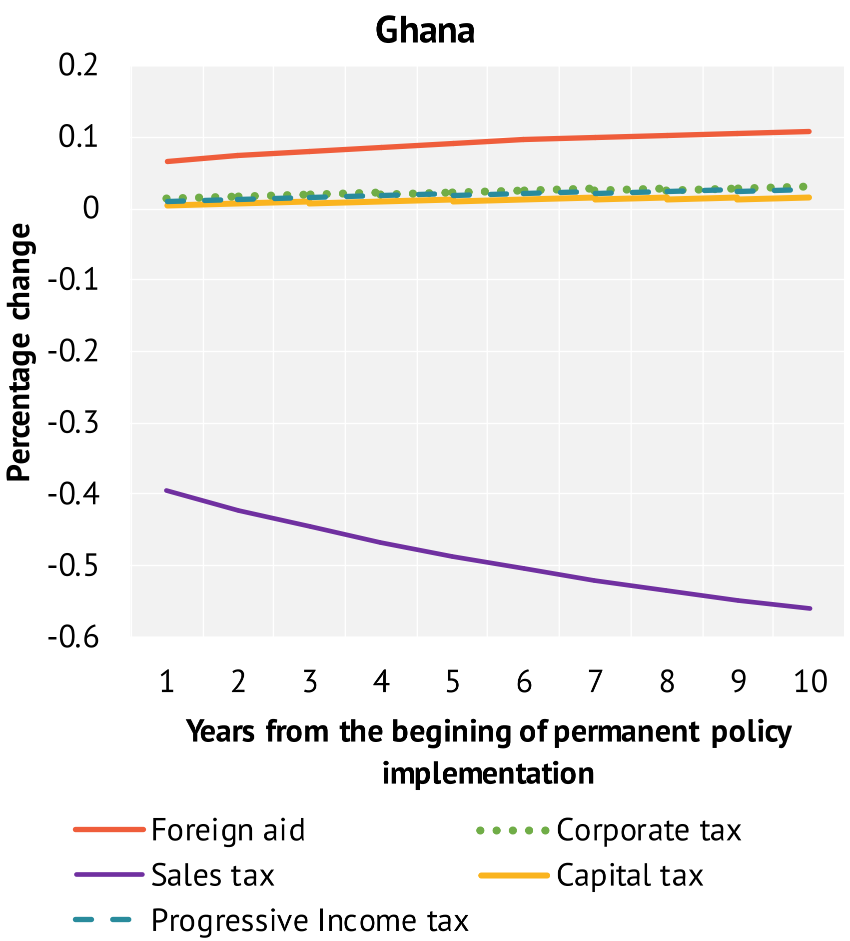


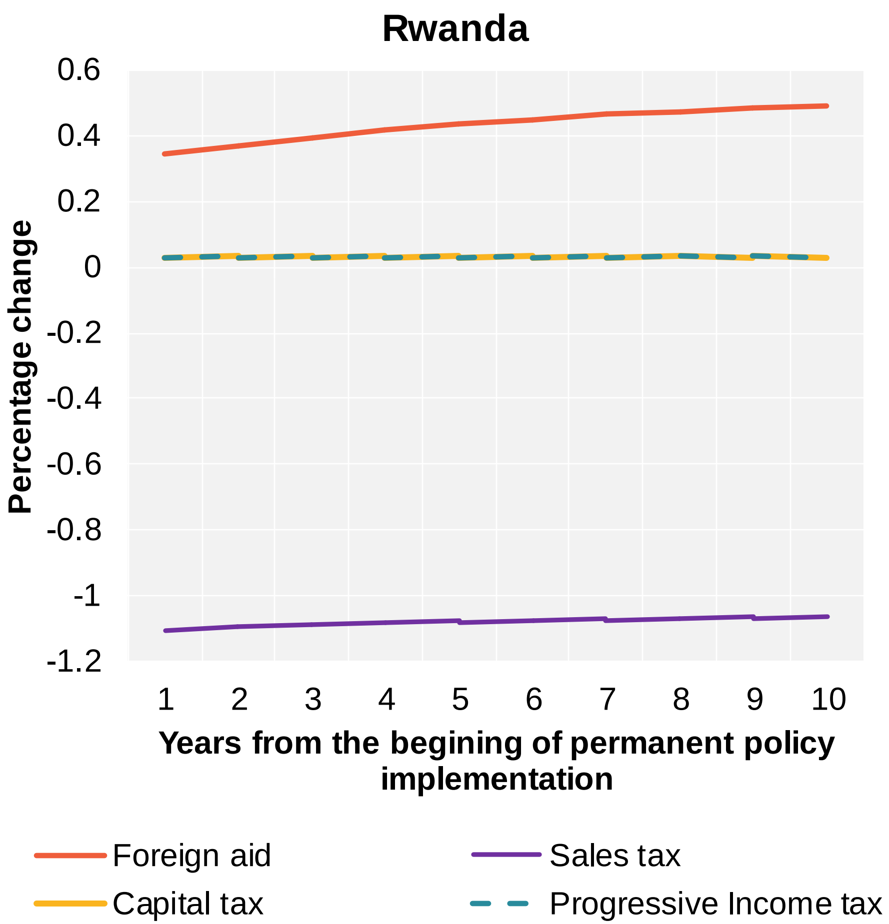


Employment

- Except for Costa Rica, Serbia and Bangladesh, investments in social protection transfers through funding from an increase in progressive income tax can generate positive, but modest surges of employment in the future
- However, consistently, financing social protection expansion through increases in VAT reduces employment over time
- If transfers are funded through corporate taxes, then the effects of social protection on employment are slightly better

Ghana and Rwanda





Conclusion

- Our findings show that financing social protection investments through progressive income taxation marginally impacts employment and GDP growth rates
- At the macro level, progressive income tax can generate positive, albeit modest changes in employment and GDP growth rates in five of the eight countries observed
- At the micro level, we find that the level of household income amongst the lowest and mid-quintiles increases substantially

Conclusion

- Governments should move away from indirect taxes, including consumption/sales and value added taxes (VAT), and seek progressive taxation such as income, capital and corporate taxes as means of increasing fiscal space and enabling additional funds for social protection investments

- Limitations
  - In the model domestic investments are heavily restricted by domestic savings
  - The model also does not consider all second order effects from social protection which may also have economy-wide impacts

Thank you