MODULE 13

Assessing affordability and impact on fiscal space

Duration: 2 hours

Prerequisites: All modules, particularly modules 10, 11, 12

Key questions:

1. What is affordability? What is fiscal space?
2. How to forecast government revenues and expenditures?
3. How to calculate fiscal space and finance fiscal deficit?
4. How to convince governments to invest in social protection?

Objectives:

This module aims to increasing knowledge on the concepts of affordability and fiscal space, as well as on the impact of expanding or implementing new social protection provisions on government budget. It also aims to provide ideas on various measures to increase fiscal space through budget reallocations or tax reforms. Finally, it aims to foster a discussion on ways to convince the government to increase fiscal space and invest in social protection.

Overview:

This module includes a presentation on affordability of proposed social protection benefits and their impact on fiscal space.

What is affordability? What is fiscal space?

Social protection schemes proposed as a result of the ABND exercises are feasible when the country concerned can afford to fund new social protection benefits. Affordability is assessed by calculating the cost of the new social protection schemes and comparing this cost with GDP. If the estimated cost of implementing a proposed social protection scenario is not much, for example, 1 per cent of GDP, it may be argued that the country in question can afford to extend the additional social protection benefits.

Depending on policy choices and the social model of the country, these additional expenditures may be:

- fully financed through social contributions (made by workers and employers);
- fully or partially financed from government budget. In such cases it is important to assess whether the government can afford these additional expenditures, i.e. whether there is sufficient fiscal space.

In the case of contributory schemes, it should be ensured that the contributions are affordable by workers and employers. In case out-of-pocket payments are required, they should not constitute a barrier to access social services. There is always a trade-off between the level of protection provided and the cost of such protection.

For the purposes of this exercise, fiscal space is defined as the budgetary capacity of a government to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy. In cases where budgetary capacity is not sufficient, the government may create additional fiscal space by raising corporate income taxes, value added taxes or personal income tax, borrowing from international institutions or markets, or cutting down on low-priority expenses. However, borrowing beyond a certain extent has to be carefully considered as it may compromise macroeconomic sustainability in the long term.

How to forecast government revenues and expenditures?

It is recommended to use official government budget projections or projections made by pre-eminent research institutes. In Thailand, for instance, TDRI's econometric model was used to project GDP and general government revenues and expenditures.

When no official projections are available, general government revenues and expenditures need to be forecasted.

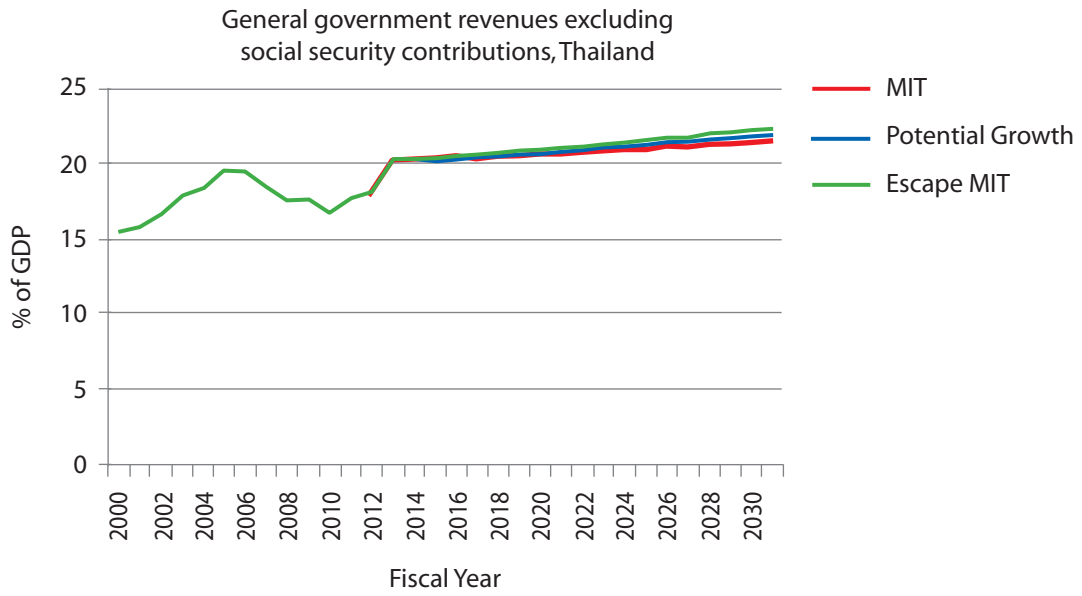
The GGO worksheet includes general government revenues and expenditures at current price.

Based on historical data, government revenues and expenditures should be expressed as a percentage of GDP at current price and then projected based on GDP forecasts:

- We collect historical data for GDP at current price and government revenues and expenditures.
- We express government revenues as a percentage of GDP at current price.
- We express government expenditures as a percentage of GDP at current price.
- We obtain future government revenues and expenditures by applying the respective percentages of revenues and expenditures to GDP forecasts (at current price).

When several scenarios of GDP growth are available, this may lead to several forecasts of government revenues and expenditures as indicated in the graph below.

Figure 23. General government revenues as a percentage of GDP in Thailand, excluding social security contributions – historical data and projections



Source: T. Sakunphanit, S. Jitsuchon, and O. Prasitsiriphol: *Health care financing for expected health care service system* (Bangkok, HISRO, 2013).
MIT: middle income trap.

How to calculate fiscal space and finance fiscal deficit?

The fiscal space is obtained by calculating the balance – government revenues minus government expenditures – and projecting this balance into the future.

In most countries, the fiscal space – the room for additional expenditures in the government budget – is equal to zero or even negative due to high indebtedness of governments. This is the case in Thailand. However, due to positive GDP growth forecasts, it is expected that the negative balance will progressively shrink and become positive after a few years' time, as indicated in the graph below.

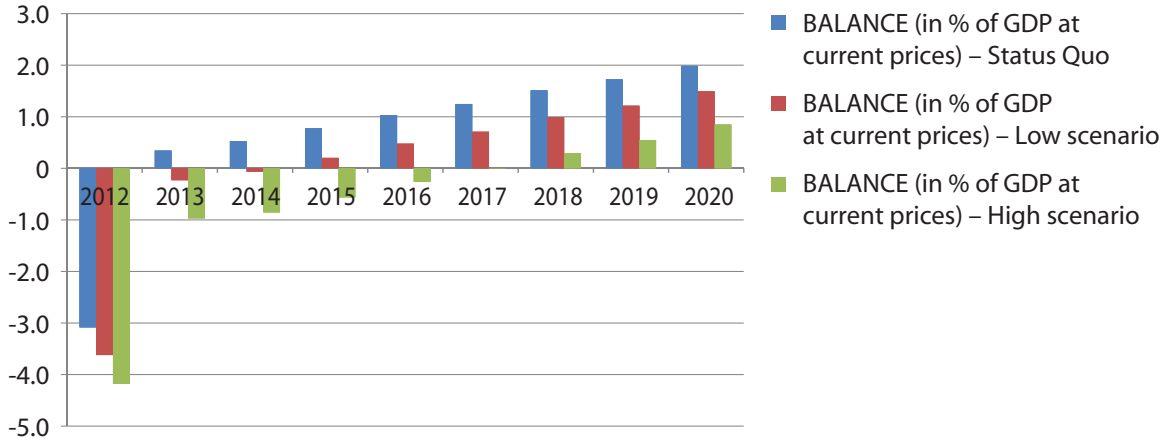
With the introduction of new social protection benefits, the government will have to borrow more (another 1 or 2 per cent of GDP), which will contribute to increasing the negative balance of the government budget. The fiscal space will start by being more negative than before and it will take longer for the fiscal space to become positive.

In Thailand, the estimated costs of the low and high scenarios were added to government budget projections. The budget balance (revenues and grants minus expenditures) was then expressed in Thai baht and as a percentage of GDP for the status quo, the low scenario, and the high scenario. This provided an initial indication of the fiscal space in case the proposed social provisions are financed entirely from government budget.

The model shows that overall government expenditures under the status quo, which includes existing social protection policies, creates a negative balance of fiscal space of around 3.1 per cent of GDP in 2012. The fiscal space balance is projected to turn positive by 2013 under the status quo assumption, which suggests that the negative balance in 2012 could be financed by borrowing. The additional cost of new social protection provisions from the low and high scenarios will increase

the negative balance of fiscal space by an additional 0.5 per cent of GDP and 1.2 per cent of GDP in 2012, respectively. The introduction of the low scenario would entail a deficit in the government's budget until 2014 and the high scenario would result in a deficit until 2017. In both cases, budget reallocations or changes in the tax structure and/or social security contributions would be needed to finance these additional provisions from the government's budget.

Figure 24. Fiscal space in percentage of GDP (status quo, low, and high scenarios entirely financed through government budget)



Source: V. Schmitt, T. Sakunphanit, and O. Prasitsiriphol, ILO RAP model for Thailand, 2013.

There are several options for financing the fiscal deficit, including raising corporate income taxes, value added taxes, or personal income taxes. One of the recommendations included in the assessment report for Viet Nam, for example, is to gradually increase personal income tax to about 1.3 per cent of GDP and increase value added tax (VAT) by about 1 percentage point, which might be sufficient to generate the resources estimated to be required for closing the SPF financing gap while keeping the overall government deficit at a projected level of 3 per cent of GDP.

How to convince governments to invest in social protection?

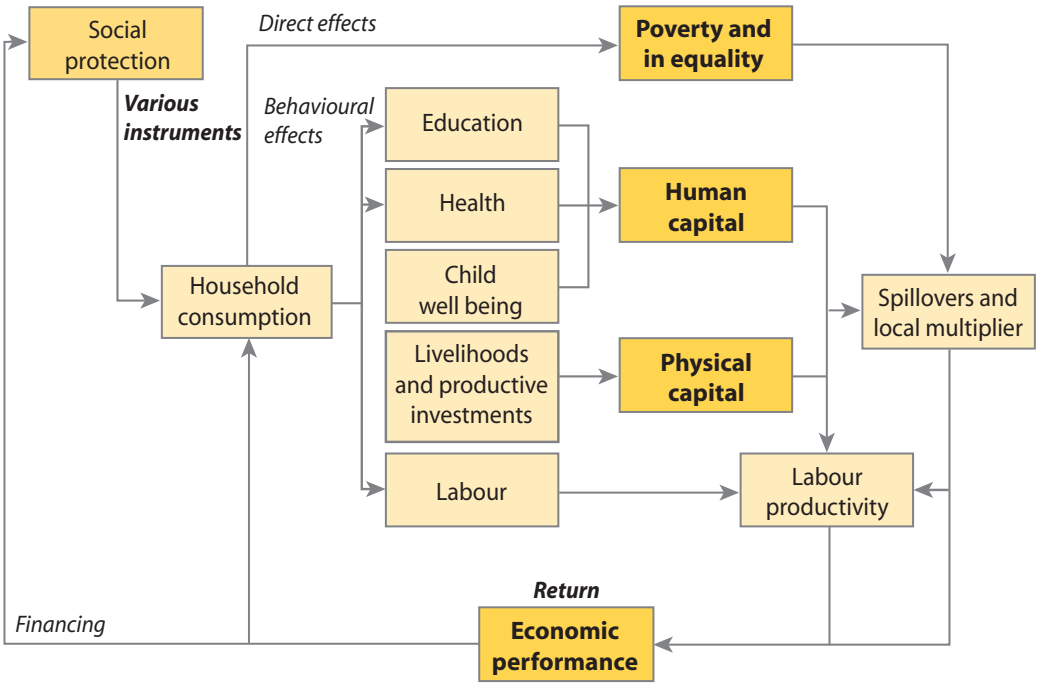
To convince the government to invest in social protection, it is necessary to perform detailed simulations (or *ex ante* assessments) of the effects of social protection policies. When a government introduces social protection, households receive benefits and their income increases, thus reducing poverty. This is the *direct effect* of social protection. While conducting the ABND in Viet Nam, an *ex ante* assessment of the impact of proposed scenarios and benefits on the reduction in poverty was conducted. This assessment simulated the direct impact of transfers on individual and household expenditures and poverty status. However, it did not take behavioural changes into account.[14]

[14] For a description of the poverty impact analysis and its results, see pp. 35–41 of M. Cichon, F. Bonnet, V. Schmitt, C. Galian, and G. Mazeikaite: *Analysis of the Viet Nam National Social Protection Strategy (2011–2020) in the context of social protection floors objectives: A rapid assessment,* Extension of Social Security (ESS) Paper No. 32 (Geneva, ILO, 2012).

There is also a *multiplier effect*. With more income and more money to spend, household members may buy food, manufactured goods, and services, thereby contributing to generating income for several sectors of the economy (agriculture, manufacturing, and service sectors).

There are also *behavioural effects*. These are caused by investments in health care and education, which lead to better health and higher productivity, and increased human capital. Graduating from university will increase the chances of having a higher paid job than graduating from primary school. Increasing the level of compulsory education and investing in the quality of education will contribute to increasing labour productivity and overall income levels. Similarly, with good health care facilities and greater access to health care services, people will be healthier, more productive workers. These productivity and income increases, if shared through adapted taxation or social contributions, will generate more fiscal space for the further development of social protection.

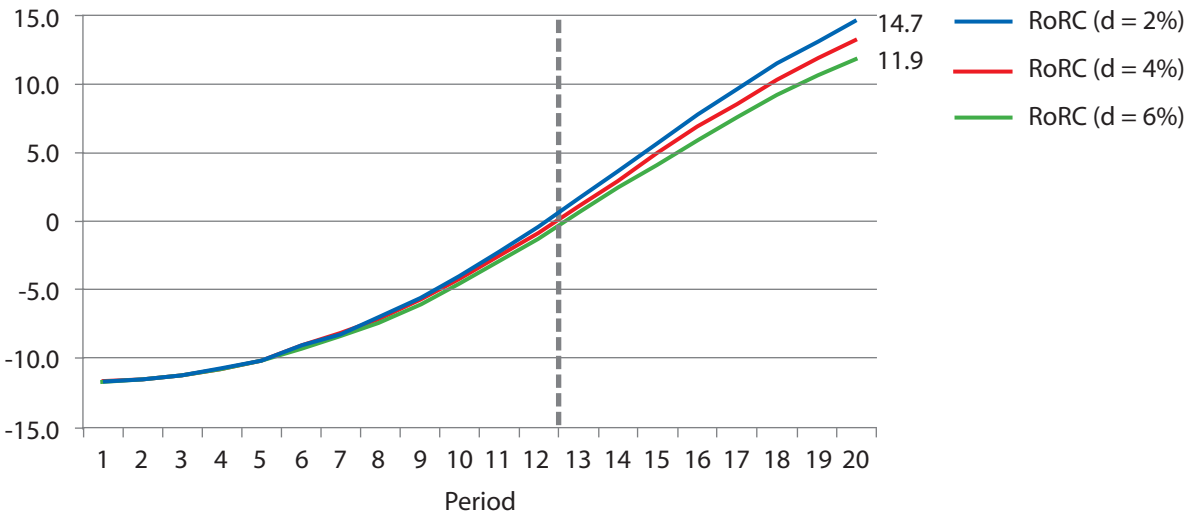
Figure 25. Social protection and socio-economic development



Source: A. Mideros Mora, F. Gassmann, and P. Mohnen, 2012, *Estimation of rates of return of social protection instruments in Cambodia: A case for non-contributory social transfers.*

Franzizska Gassmann from the Maastricht University conducted a study on social protection as an investment and found that social protection in Cambodia creates between 11.9 per cent and 14.7 per cent return on investment in 20 years. Social protection can be considered as an investment in human capital and compared with investments in infrastructure such as dams, trains, and roads. The model developed by Franzizska Gassmann shows also that although return on investment may vary across countries, the combination of several social protection benefits will generate higher returns than the provision of several social protection benefits separately.

Figure 26. Simulated rate of return on social protection investment in Cambodia



Source: A. Mideros, F. Gassmann, and P. Mohnen: *Estimation of rates of return of social protection instruments in Cambodia: A case for non-contributory social transfers* (Maastricht, Maastricht Graduate School of Governmance, 2012).

The direct, multiplier, and behavioural effects of social protection investments on poverty reduction and inclusive growth also need to be measured *ex post* through the establishment of comprehensive monitoring and evaluation systems.

Takeaway message:

Whereas the concept of affordability relates to the capacity of a country as a whole to finance additional social protection benefits, that of fiscal space indicates whether the government can afford financing these benefits from its own budget. Adding new social protection benefits will inevitably result in deteriorating the fiscal balance. Thus, ways to reduce the deficit need to be devised by increasing government's resources or cutting "unnecessary" expenditures and reallocating the available resources to social protection. In any case, the government needs to understand that social protection shall not be considered as a cost but as an investment in human capital.

Resources:

		textbook	*e-box*
	Module 13 – Assessing affordability and impact on fiscal space	✓	✓
	Presentation – Assessing affordability and impact on fiscal space		✓
	Affordability and fiscal space		
	Part 1 – Fiscal impact of the social protection floor		✓
	Part 2 – Rate of return of the social protection floor		✓

e-box available at: http://www.social-protection.org/gimi/pages/abnd/