Financing social pensions in low- and middle-income countries

Introduction

There is an increasing recognition that people in low- and middle-income countries (LMICs) need better support through social protection mechanisms that reduce chronic poverty and build human capital. Among those who need social security are millions of older people who, having worked all their lives in the informal sector, are left in poverty without pensions or other regular income.

With traditional family support systems eroding, millions work well into old age until ill health or frailty stops them. Governments in developing countries have now recognised the impact social pensions can have on reducing old-age and intergenerational poverty. Nepal, Lesotho, Bolivia, Brazil and South Africa are among over 80 countries which have set up social pension schemes. Those countries that have introduced broad-based and near-universal schemes, such as Brazil, have significantly reduced old-age poverty rates. Out of these 80 countries, 47 are LMICs.

Social pensions have recently been recognised as a key component of the United Nation’s Social Protection Floor – one of nine UN initiatives agreed in 2009 to reduce the social impact of the global economic and financial crises. Social pensions reduce poverty and vulnerability not just for older people, but also for their families and in particular for orphans and children in their care.

The debate about introducing social pensions is often set against the background of fiscal constraints and government concerns that implementing such pensions could generate long-term liabilities beyond the budgetary capacity of developing countries. This paper presents an overview of the different options available to finance new social pension schemes or to scale up existing ones. It aims to provide useful learning for countries considering the implementation of social pensions, as well as the financing of other cash-transfer and social protection programmes.
1. Current debates and key considerations

Over the last few years, governments in LMICs as well as many donors and aid agencies have begun to debate, analyse and test the impact of social cash-transfer mechanisms on poverty reduction. Extensive evidence is now available on the role and effectiveness of universal or near-universal social pensions in alleviating the poverty and vulnerability of older people and their wider households. The evidence also suggests that these schemes can be implemented even in countries with low administrative capacity, sharp urban/rural divides, and underdeveloped financial systems. However, despite this plethora of evidence, several key questions continue to be asked.

One of the key questions raised is whether developing countries can afford a social pension pillar. The cost, considered one of the key factors in determining affordability, is dependent on two variables: size of population receiving the benefit and level of pension payout. As current practice shows, a number of LMICs including Nepal, South Africa and Swaziland have already put in place social pensions which cover all – or most – older people. The cost of such schemes ranges from 0.4 per cent of GDP in Botswana to just under 2 per cent of GDP in Mauritius. Meanwhile, HelpAge International’s costings show that most sub-Saharan African countries could put in place a basic universal pension for everyone over 65 for around 1 per cent of GDP or less.

However, it would be a mistake to look at affordability solely from the perspective of costs. Affordability is highly dependent on political will and policy priorities. National and regional geopolitics also play a key role in the decision-making process. Although opponents of social transfers often cite lack of available financial resources as the key stumbling block, the examples of countries such as Bolivia, Lesotho and Nepal demonstrate the increasing interest in, and relevance of, universal social pensions in southern Africa and south Asia and indicate a shift in political preferences in recent years.

Another key issue is whether developing countries can finance a social pension through taxation. Evidence from existing schemes shows that a whole range of tax revenues are used to finance them. Several governments such as Lesotho and Swaziland pay for their universal social pension schemes out of general taxation. In Costa Rica, in 2000 the pension was financed through the sales tax (48.3 per cent), payroll taxes (46.2 per cent), alcohol and cigarette taxes (5.4 per cent) and accrued interest on judicial deposits and bank accounts (1.7 per cent). Before Thailand’s pension scheme was made universal it was funded through a mixture of taxation from national and local government social security contributions.

These examples demonstrate that there is not a “one size fits all” answer as to which tax revenues are most appropriate: many different options are available. This paper provides some guiding principles on how social pensions can be financed through taxation in a fair and equitable manner. Fairness in this context means that the poor do not pay disproportionately more tax as a proportion of their income than the rich. The paper also looks in some detail at mechanisms by which a government can finance a social pension through taxation as well as the roles overseas donor assistance, debt relief and reallocation of resources can play.

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3. The HelpAge International Pension Watch website has a pension calculator which can be used to work out the cost of universal pensions in 175 countries across the globe, www.pension-watch.net
2. Financing social pensions

2.1 Fiscal space, development policies and social expenditure

Affordability of government spending tends to be based on the concept of fiscal space. The IMF defines fiscal space as availability of budgetary room that allows a government to provide resources for a desired purpose without any prejudice to the sustainability of its financial position.7

Fiscal space is not a static or predefined space but a dynamic concept subject to political priority setting as well as weighing short-term against medium- and long-term expenditure planning. This is particularly relevant to financing universal social pensions which need to be planned for well in advance, taking into account, for example, demographic trends and growth.

As is the case with most government spending there are competing priorities, both with regard to the appropriate balance of spending within the social sector and the appropriate allocation of limited resources between sectoral budgets such as industry, agriculture, infrastructure and defence.

International frameworks such as the Millennium Development Goals (MDGs) further influence government decisions on which sectors to prioritise in order to meet targets and qualify for aid. Another factor influencing decisions over spending is a government’s seriousness and commitment to resourcing existing national policy commitments such as national development strategies, plans of action on ageing etc.

Whilst aid frameworks and international agreements do set some parameters for investments in the social sectors, such as health and education, developing more comprehensive and long-term social assistance such as social pensions requires a demand-driven political process by which citizens can hold governments to account. Without a broad-based political and societal consensus on how best to translate the right to social security into practice, the necessary long-term investments (that is, the creation of fiscal space for long-term social protection systems) are hard to come by.

Generally, the allocation of fiscal space needs to be considered over the medium term of three to five fiscal years, and embedded in public financial management frameworks such as the Medium-Term Expenditure Framework. There is no widely accepted quantitative measure of fiscal space, but some measures are commonly used to assess a government’s long-term fiscal capacity. These measures include the fiscal balance, tax revenues, official development assistance (ODA) and the prioritisation and efficiency of resources (see box).8

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**Measures that determine fiscal space**

- **Fiscal balance**: the balance of a government’s tax revenues, plus any proceeds from asset sales, minus government spending: if the balance is positive, the government has a fiscal surplus; if negative, a fiscal deficit
- **Tax revenue**: income gained by the government through taxing citizens, households and businesses
- **Official development assistance (ODA)**: a source of government revenue in the form of aid, concessional loans and debt forgiveness
- **Prioritisation of resources**: from lesser to higher priorities, and from less efficient to more efficient and productive programmes.9

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A commonly used indicator to assess the nature and effectiveness of fiscal policy is the overall fiscal balance, which measures the difference between revenues and grants, and expenditure and net lending. In LMICs, key issues when it comes to fiscal space include aspects of aid dependency or dependency on a limited number of exports which are often subject to price volatility on world markets. It is a country’s ability to diversify tax income and economic activity that results in a more reliable income stream and fiscal space.

2.2 Taxation and equity considerations in LMICs: emerging principles

Taxation is the main principle for financing social spending as it is the most appropriate way to ensure that spending is government-driven and sustainable in the long term. It is, however, critical to consider whether the impacts of direct and indirect taxation are progressive or regressive in nature and whether the tax burden on the population is perceived to be fair. In the context of widespread inequality, taxes need to be progressive in order to reduce inequalities and poverty.

As LMICs consider options for increasing their tax base, policy makers need to look at the impact of different tax revenues on tax payers. Taxes have distributional consequences as to who gains and loses – also known as the tax incidence. For example, if a tax increase to finance a social pension raises the tax burden on the poorest households, then the poverty reduction impacts of a pension may be counteracted for those households. A tax is considered progressive if it taxes poorer households less than wealthy ones. A regressive tax takes a larger percentage of income from poor households than rich households.

Lack of administrative capacity and inadequate record keeping are challenges to effective and fair taxation. Further constraints include the general lack of trust on the part of citizens in the quality of public spending, and the unbalanced tax mix, as governments rely excessively on a narrow range of taxes to generate revenues, with some stakeholders disproportionally represented in the tax base.

It is therefore critical that domestic tax collection and effective tax systems are developed. They can help to foster good governance through a more constructive dialogue between the state and its citizens over how taxes are spent. Paying taxes, both directly and indirectly, gives citizens more incentive to pay attention to policy formulation and resource allocations, thereby enforcing accountability and creating a demand for greater provision of public services. Furthermore, when confronted with large or new demands for taxation, citizens will be more likely to mobilise politically.

Effective taxation lays the foundation for governments to provide not only a long-term and sustainable social pension but also other social expenditure. However, the high level of inequality in most developing countries means that governments face a difficult situation. They need to tax the politically powerful wealthy elites and middle classes to raise significant revenues in an equitable manner, but are unable to do so easily. Elites and middle classes are more likely to support social spending when it is accessible to all citizens in the form of a universal entitlement and its financing is broad-based. Taxpayers will be more willing to pay tax if they know that the tax paid will benefit them no matter what their economic status.

10. IMF, Guidelines for fiscal adjustment, Pamphlet Series No 49, Fiscal Affairs Department, IMF, 1995
Principles

- The favoured option for financing social spending is through general, broad-based taxation, which ensures that it is government-driven and sustainable in the long term. Taxation is a key function of the state-citizen relationship and can foster good governance through a more constructive dialogue between the state and its citizens.
- Taxation for financing social spending should be progressive. The distributional impacts of increasing tax need to be considered on a country-specific basis.
- Developing countries need to strengthen their tax administrations to improve the efficiency of tax collection. The international community has a key role to play in providing support to enhance the administrative capacity of partners through sharing best practice and providing technical assistance.

2.3 How LMICs finance social pensions: lessons from existing schemes

This section describes a range of mechanisms for financing social pensions in LMICs. It is important to note that some of the financing options outlined below are appropriate for covering the initial investments needed to set up systems (for instance, tax systems and registration), but would not be appropriate to ensure the long-term financing of social schemes.

2.3.1 Options for increasing tax revenue

Tax revenues are one of the key income streams available to government. Generally speaking, the lower the tax revenue as a proportion of GDP, the greater the opportunity that is available to boost government revenue. The average tax revenue in OECD (Organisation for Economic Co-operation and Development) countries is 35.8 per cent of GDP. In comparison, the majority of LMICs have much lower tax revenues: for example, tax revenue ranges from 8.1 per cent of GDP in Cambodia to 23 per cent in Ghana (Figure 1).

One study found that raising tax revenue by just one percentage point – from 13 to 14 per cent of GDP in a country like Burkina Faso – would be enough to finance a universal pension for all those aged 65 and over. However, in addition to equity concerns highlighted above there are further challenges in increasing revenues in natural resource-poor and agrarian countries. For example, governments face difficulties in raising direct tax revenue when the informal sector in LMICs occupies 40-90 per cent of the economy. In such contexts, tax collection from employment offers very limited opportunities to raise significant government income.

Also, as countries reform tax revenue policy (for example, through reducing tax exemptions) expenditure on universal pensions can be prioritised from the revenues leveraged from these reforms.

16. OECD Tax Database, table 0.1 www.oecd.org/document/60/0,3343,en_2649_34533_1942460_1_1_1_1,00.html#trs (12 December 2010)
Key issues to be taken into consideration when deciding on different tax options are outlined below, bearing in mind the principles already identified.

**Consumption taxes**

A consumption tax is an indirect tax levied on spending on goods and services. The advantage of consumption taxes is that they tend to track GDP and that they provide a wide tax base (the tax is taken from every person who buys any goods or services). Consumption taxes are paid by everybody according to their income or consumption patterns and levels of spending. The World Bank recommends that a social pension be financed through a broad-based tax, such as an income or consumption tax, rather than a payroll tax.18

The most relevant consumption tax to consider is Value-Added Tax (VAT), which is a consumption tax that is levied on the value-added stage of production. There may be different VAT bands depending on the type of goods and services. For governments seeking to increase their tax base, recent studies have found that taxes levied at low and relatively flat rates across a broad base of goods and services are easier to collect and administer.19

In some LMICs, this can be one of the most important sources of tax revenue. For example, in Peru, VAT is set at 18 per cent and accounted for more than two-fifths of tax revenue in 2000.20 In Sri Lanka, VAT accounts for two-thirds of tax revenue.21 A study on the feasibility of a universal pension in Sri Lanka estimated that a small increase in VAT – from 5.0 to 5.5 per cent (along with similar small increases at higher levels of VAT) – would pay for a pension for everyone aged 70 and over.22

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18. World Bank, Averting the old age crisis: policies to protect the old and promote growth, World Bank, 1994, p.243
21. Kidd and Willmore, p.27
22. Kidd and Willmore, p.27

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Figure 1: Tax revenue as a percentage of GDP for selected LMICs

![Figure 1: Tax revenue as a percentage of GDP for selected LMICs](chart)

To prevent VAT increases from being regressive it is important to set it at a low level on basic necessities such as staple food and basic goods. Otherwise poor people would have to pay disproportionately more of their already scarce income to meet their most basic needs. This would have a direct negative impact on poor households, as food comprises a high proportion of their consumption expenditure.

VAT may often be much less regressive than is sometimes assumed because of exemptions on basic commodities and the fact that a large proportion of retailers in LMICs fall below the VAT threshold. One study of eight sub-Saharan African countries found that broad-based taxes such as VAT were progressive and did not put a high or inequitable tax burden on poor people. However, it is important to look at the impact of VAT levels and distribution on different social-economic groups on a country-by-country basis.

Another way to increase tax revenues is through increasing excise taxes, collected through goods such as beer, cigarettes and petroleum, whose consumption creates “negative externalities”. In Costa Rica, data from 2000 shows that the social pension scheme received 5.4 per cent of revenue from taxes on alcohol and cigarettes. The advantage of using a tax with negative externalities is that it may be more politically acceptable to increase the tax, particularly if the revenue is redirected towards social expenditure.

Payroll taxes and personal income taxes

In developed countries, raising public expenditure on social protection has been achieved by shifting the composition of tax revenues towards income, especially payroll taxes. This has been applied in some middle-income countries (MICs), where social benefits have been financed through taxing the wages of those in the formal sector. In Brazil, the Benefício de Prestação Continuada (BPC) is a means-tested cash transfer paid to older people in urban areas, which includes transfers to extremely poor individuals with disabilities. BPC payments are part of the social security system and are financed mainly by taxes on the wages of formal sector workers.

The option of increasing payroll (social security) taxes to fund social pensions is not available to all middle-income countries let alone to low-income countries (LICs) because the proportion of the population working in formal employment is relatively small. The International Labour Organization (ILO) estimates that the informal economy accounts for 78.2 per cent of employees in Asia, and 56 per cent in Africa. However, in many LICs in Africa the informal sector is even larger, covering 80-90 per cent of the work force. Thus the amounts of tax collected from formal sector employees and employers in these countries remain low. For example, the average tax on personal income and profits in Africa amounts to only 6 per cent of GDP.

A further disadvantage of using payroll taxes is that they may reduce the incentives for workers on the margin of the informal sector to move into the formal sector if the benefits associated with it do not outweigh the costs. In addition, employers may also conduct business in the informal rather than formal sector to avoid paying taxes.

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23. Prichard and Bentum, p.15
24. Sahn DE, Younger SD, Dominance testing of social sector expenditures and taxes in Africa, WP/99/172, Fiscal Affairs Department, International Monetary Fund, 1999
25. Externality refers to situations when the effect of production or consumption of goods and services imposes costs or benefits on others which are not reflected in the prices charged for the goods and services being provided. A negative externality is an action of a product on consumers that imposes a negative side effect on a third party; it is “social cost”.
27. Barrientos A, Financing social protection, Brooks World Poverty Institute, University of Manchester, 2007
Natural resource and other related tax revenues

A resource tax is particularly relevant for mineral-rich developing countries, enabling them to increase fiscal space with relatively little public administrative capacity needed for tax collection. Using a resource tax to finance a social pension can help to develop effective institutions and good accountability mechanisms, strengthening systems of good governance.

In Bolivia, the universal pension, introduced in 1997, was financed in part from a fund set up with proceeds from the partial privatisation of five large public enterprises.31 The sale of Bolivia’s utility companies enabled the government to pay an annual social pension of 1,800Bs (then US$220), called the Bonosol, to every man and woman over the age of 65.32 In 2007, due to dwindling resources from the privatisation fund, the government shifted the financing source to the Direct Hydrocarbon Tax, which had been set up as part of the country’s gas nationalisation programme. In the meantime, the pension was rebranded the Renta Dignidad and extended to everyone over 60 years of age.33 Bolivia is currently looking at ways of shifting the spending on the Renta Dignidad to general tax revenue.

At a first glance, resource-rich countries seem to have an advantage in terms of increasing tax revenue, but this is not necessarily the case. Some resource-rich nations depend too heavily on exports (for example, oil or minerals). This can easily lead to a lack of investment in other sectors such as agriculture and industry, as well as preventing the development of effective tax systems and institutions. However, the Bolivian experience shows how revenue from natural resources can help to bridge the gap to longer-term financing.

Corporate taxes

Corporate income tax is a tax levied on profits made by businesses. In principal, a social pension could be partly financed by taxing a specific sector such as tourism or agricultural business (as opposed to small-scale farming and subsistence agriculture and pastoralism). For example, in Brazil, the rural pension is partly financed by corporate taxes through a 1 per cent tax on rural produce and a separate 2.5 per cent wage levy on urban enterprises.34 In total, revenues from the tax on rural produce pay for only one-tenth of benefits. The majority of funding comes from the urban social insurance scheme and other government revenues.35

In the majority of LMICs, corporate taxes tend to have rates differentiated by sector,36 but it is important to ensure that this does not have a distorting impact on the market, as firms can reallocate investments and production to other sectors and larger companies are also known to move location to other countries where taxation is lower.

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Another question to consider when raising corporate taxes is who bears the cost. This may result in shareholders (or all owners of capital) receiving lower returns, consumers paying higher prices, or workers receiving lower wages – or a combination of all three.\(^{37}\) When increasing a corporate tax, it is therefore important to consider whom companies pass the tax burden on to. It is also important to address tax evasion and fraud by companies. Governments need to put in place measures to mitigate both these risks.

Generally, there is limited evidence of corporate taxes being used widely to increase fiscal space and government revenue. It also reflects the limited scope of tax institutions, not only in LMICs but even in high-income countries, to enforce equitable corporate tax systems and address tax evasion and fraud.

To summarise, it is critical to take into account country-specific characteristics and invest in tax systems and tax reforms by strengthening tax administration and mitigating tax evasion and fraud. Generally, the most appropriate options to fund long-term expenditure such as social pensions include taxes that are progressive and broad-based, ie, taxes which ensure that the poor do not pay disproportionately more tax as a proportion of their income than the rich. Also, it is important to ensure that tax revenues are as diverse as possible, decreasing the over-reliance on any one tax source, and as far as possible de-linking tax revenue from economic cycles.

### 2.3.2 Overseas development assistance (ODA)

Through the UN Social Protection Floor Initiative and increasing investments by aid donors, more work is now being done to develop social protection strategies and support national social protection policies and expenditure. ODA can also play an important role in supporting the initial direct funding of social pensions while the administrative and tax systems needed for long-term sustainability are being developed. This provides a clear exit strategy for ODA funding.

Over recent years, small-scale cash transfer pilot projects have received a good deal of investment from donors. However, these pilots face the challenge of sustainability. If they cannot build sufficient government capacity and ownership and if they are not translated into entitlements, they are unlikely to become embedded in government expenditure. In donor-funded cash-transfer programmes such as in Zambia and Kenya, it is not yet clear whether there is sufficient political will, and hence funding available in the long term, for government to take over these schemes and scale them up to reach national coverage.

The following are some key lessons and suggestions on the use of ODA funding for the introduction and implementation of social pension schemes.

**Donor financing needs to be predictable and governments’ own tax resources need to be developed.** Many donors are unable to commit beyond the medium term and are often constrained by the length of their own political cycle.\(^{38}\) Sustained, predictable flows of aid are important if social pensions are to be set up or scaled up nationally\(^{39a}\) while at the same time, the national resource base is expanded. Using donor funding to expand social pensions on a permanent basis is unsustainable and carries the risk that this may be revoked.

**Donors should invest in building the capacity of civil society to increase political debate, demand and accountability.** Even where governments show political will to increase fiscal space and social expenditure, it is critical to enable civil society to engage with government and to increase citizens’ awareness of their rights and entitlements. Donor engagement in countries such as Kenya and Tanzania has enabled civil society organisations such as older people’s associations to demand social transfers and hold their governments to account once programmes are set up. This approach strengthens the accountability of governments and provides democratic structures of engagement between state and citizen.

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38. UNICEF/ODI, 2009
Donors should fund capacity building and technical assistance to create a national and context-specific evidence base. Donor support can provide critical momentum to enable Ministries of Social Welfare, or other relevant ministries tasked to reduce poverty and inequality, to work towards building wider cross-sectoral political support, especially from Ministries of Finance and Planning. Capacity building, learning from existing schemes in other countries and feasibility studies, undertaken through national consultative processes, are important milestones which ODA can fund in the short and medium term.

Donors should support the development of a legislative social protection framework and national social protection policies. Donors and other development actors can play an important role in supporting the development of a legal framework for social protection. Such donor support contributes indirectly to ensuring that governments finance social transfers out of taxation. It can provide an enabling environment which promotes government ownership, and leads to social pensions becoming enshrined as a citizens’ right and thus a core function of the state.

2.3.3 Debt relief

Debt relief can free up fiscal space by using the payments that would have been spent on debt obligations to finance social spending. Low-income countries have benefited from debt relief from the Heavily Indebted Poor Countries (HIPC) Initiative, launched in 1996, which aims to ensure that no poor country faces a debt burden it cannot manage.

Before the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined. The Multilateral Debt Relief Initiative (MDRI) allows three multilateral institutions – the IMF, the World Bank, and the African Development Fund (AfDF) – to provide 100 per cent relief on eligible debts for countries completing the HIPC Initiative process. The MDRI is intended to help them progress towards achieving the MDGs, hence the importance of understanding how social pensions accelerate progress to achieve MDGs.

A key mechanism to increase fiscal space for social expenditure is to ring-fence savings derived from debt relief, separating them from other public expenditures. Experience from Uganda and Zambia shows how debt relief savings were committed to a poverty action fund and poverty reduction programmes. However, it is important explicitly to include social services and transfer programmes in poverty reduction strategies, and specifically earmark debt relief funds as a key mechanism to improve human development outcomes through social services and transfer schemes such as a social pension.

Thus, earmarked debt-relief savings spent through the standard channels of government can become an entry point to planning, budgeting and implementing a social pension. A further advantage of debt relief is that it is comprised of domestic rather than external funds, which gives domestic reformers greater flexibility in deciding on their use.

A critical aspect of using debt relief for social spending is that there is a public and political dialogue between citizens and the state as to how freed-up debt relief resources are spent. Donor support to design and fund set-up and capacity-building for social pensions could be made available to complement debt relief funds.

2.3.4 Reallocation of resources

For countries considering expanding investment in social transfers, another option for financing a cash transfer, such as a social pension, is to shift expenditure from other areas of government spending. Where this is based on cutting inefficiencies or reducing inequitable allocation of government resources, this is clearly an important option. In Mexico City, for example, the social pension was financed by reducing senior officials’ travel and salaries without raising additional taxes or debt.
Reducing unproductive expenditures, particularly those of a recurrent nature, is another option for governments seeking to expand social protection programmes. This requires ongoing monitoring and evaluation efforts that can provide evidence on which programmes are productive and which ones are unproductive. The creation of fiscal space through expenditure switching also requires a good and transparent budgetary process. This can be done by ensuring that social protection is included in the Medium-Term Expenditure Framework.

An important consideration when creating fiscal space is to balance spending in and between different sectors. Governments need to ensure that spending on universal pensions is not treated as a trade-off with investments in other social areas, especially basic social services. The impact of universal social pensions is greatest where good access to quality health and education services is available to the poor. This in turn significantly contributes to strengthening human capital.

However, reallocation of resources within the social sector ought to be considered where a large proportion of government budgets is spent on civil servants’ pensions, which benefit a very small percentage of people. In Kenya, the government spends over 1.4 per cent of GDP on civil service pensions, while all other forms of social protection account for only 0.3 per cent of GDP.44

### 2.3.5 Government borrowing

Increasing government borrowing is not a sustainable option in the medium to long term. Borrowing from external or internal sources requires repayment. Governments need to consider whether the return on the expenditure justifies the cost of the borrowing, and if the spending will enhance government revenues to finance loan repayments.45 Increasing government borrowing will lead to a substantial budget deficit and a rise in public debt. The consequence may be to push up the level of interest rates and therefore crowd out borrowing from the private sector, with adverse implications for future investment and growth.

It is generally considered that borrowing to finance investments should be limited to infrastructure projects only. However, there are some examples where this is not the case. Barrientos has highlighted the fact that all but one of the conditional cash transfers in Latin America are financed either partially or wholly by World Bank and Inter-American Bank loans.47 This could raise questions over their sustainability. Social protection expenditure is recurrent and long term in nature and even though it indirectly contributes to economic growth it is not recommended to borrow in order to finance a social pension. Interestingly, the same study found that all social pensions in the same region were funded from domestic revenue.

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45. Heller, 2005, p.9
46. Conditional Cash transfers (CCTs) are programs that transfer cash, generally to poor households, on the condition that those households make prespecified investments in the human capital of their children. Fiszbein A, Schady N, Conditional cash transfers: reducing present and future poverty. World Bank, Washington D.C., 2009, p.1
3. Conclusions

The experience of LMICs shows that they have been able to use innovative approaches to financing social pensions. Countries such as Mexico, Brazil, Thailand, Costa Rica and Bolivia demonstrate a variety of sustainable financing methods from general taxation as well as payroll and consumption taxes, expenditure switching and taxing natural resources.

For states falling into the HIPC category, debt relief is an attractive financing option as it has the advantage of being comprised of domestic funds, which can allow greater flexibility over their use. Equally relevant is the option of expenditure switching, which is particularly relevant where unproductive or ineffective government programmes can be stopped, thus contributing to more effective resource allocation.

The international aid community has a key role to play in providing support to enhance the administrative capacity of governments in LMIC, sharing best practice and providing technical assistance. Moreover, the aid community can contribute to financing one-off expenses involved in setting up social pension systems (such as creating legal identity and registration systems) and strengthening the role of civil society in engaging with and holding government to account. The social protection sector in low-income countries can also consider lessons from the aid financing of the health sector where, in many sub-Saharan African countries, aid finances around 30 per cent of all health spending – much of which is allocated to recurrent funding of salaries.

Above all, fiscal space needs to be considered in a country-specific context, as it is dependent on the specific national circumstances, including political priorities and macroeconomic conditions. Eventually, the chosen financing option will be based as much on political debates and decisions as on technical considerations. What is clear, however, is that there are a number of options open for investigation for countries aiming to increase fiscal space in order to fund social pensions in the long term.

Find out more:

www.pension-watch.net

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