

Informal readout

The Working Group on Financing under USP2030 workplan includes an open discussion forum and knowledge exchange on emerging topics. These discussions are held under the Chatham House rule to enable shared learning and open exchanges of views. This informal read out aims to capture these frank discussions between partners without attribution in order to give a sense of areas of consensus, disagreement and pathways forward. This read out covers a discussion on the following two questions:

1. Can informal workers be successfully integrated into contributory social protection systems and pay contributions?
2. Are increased taxes on the informal economy necessary and effective tools to increase financing for social protection?

Given the interaction between these issues, the questions were discussed together as reflected in this read out.

Meeting background

The meeting was held online on February 7th, 2023. Convened by UNICEF and WIEGO, it included the following partners: Act Church of Sweden, BRAC, European Commission, FAO, German Institute of Development and Sustainability (IDOS), Handicap International, ILO, IMF, ITUC, OECD, Sida, UNICEF, WFP, WIEGO, WSM and the World Bank. Introductory perspectives were provided by the ILO, IMF, OECD, the World Bank and WIEGO followed by an open discussion.

Context

The majority of the world's workers work in informal employment, working without labour or social protections: Globally, 61 per cent of all workers – around two billion – are informally employed. The percentage rises to 90 per cent of workers in developing countries. Informal employment is a large and heterogeneous category. For purposes of analysis and policy making it is useful to first subdivide informal employment into self-employment and wage employment, and then within these broad categories, into more detailed categories of status in employment.

Informal self-employment includes employers in informal enterprises, own account workers in informal enterprises, contributing family workers (in informal and formal enterprises), and members of informal producers' cooperatives. Informal wage employment includes employees hired without social protection contributions by formal or informal enterprises or as paid domestic workers in households. Certain types of wage work are more likely than others to be informal, including employees of informal enterprises, casual or day laborers, temporary or part-

About Informal Readouts

Informal readouts represent summaries of discussions by USP2030 financing working group members on pressing or emerging issues under the Chatham house rules. They aim to capture key readouts of frank discussions between partners without attribution, in order to give a sense of areas of consensus, disagreement and pathways forward.

time workers, paid domestic workers, contract workers, unregistered or undeclared workers, and industrial outworkers (also called homeworkers).

Despite facing higher risks of poverty than formally employed workers, informal workers rarely benefit from social protection. While generally excluded either de jure or de facto from social insurance linked to formal employment, informal workers also tend to fall outside of social assistance targeted towards those in poverty or outside the labour market. Expanding social protection coverage to informal workers is therefore fundamental to achieving USP. However, the limited progress to expand social protection to informal workers points towards important challenges to the financing and implementation of USP that can emerge at the nexus between informality and unsuitable tax and benefit systems. The discussion and knowledge exchange focused on the two most important issues regarding the financing of social protection: social security contributions and taxation.

Discussion summary

Key points of agreement

Importance of making progress on the extension of social security coverage to the informal economy to ensure high levels of protection and sustainability through broad-based financing strategies.

Participants were united in expressing the view that in order to achieve USP, progress not only needs to be made in the expansion of tax-financed social assistance but also in expanding contributory social security to the informal economy.

While there is disagreement about the future of relevance, design and financing of contributory schemes, it was clear to all that social security contributions currently play a substantial role in the social protection financing mix. Furthermore, there was agreement that the scale of the USP financing challenge requires combining all available financing mechanisms, in particular social security contributions and taxes, into one broad-based and diversified approach. Combining and balancing available mechanisms, each with their own strengths and weaknesses, was seen as key to not just increasing the financing available for social protection but also to spreading the burden widely and equitably, as well responding to the different objectives of social protection (poverty protection, consumption smoothing, etc.).

Informality will likely remain a reality at least in the medium-term and social protection systems need to adapt to that reality.

There was an agreement that in many contexts informality constitutes a reality that is not going to change quickly and therefore it is important that social protection systems are adapted to this reality. Rather than wishing it away, we need to (re)think how social protection systems can account for informality that is both widespread and persistent. The question is how we can adjust our schemes and systems to make them more responsive to this reality and inclusive beyond those in standard employment relationships.

There are no quick fixes and one-size-fits all solutions – but important progress can be made in making systems more inclusive, as experiences around the world show.

Following on from the consensus regarding the informal economy's heterogeneity, participants argued there is not one singular solution, but rather that progress will be piecemeal and context specific. Indeed, one of the strongest agreements was on not regarding informal economy actors as one group. Similarly, participants agreed that ambitions to expand coverage to all informal economy actors at once are misguided.

A likely more fruitful approach would be to explore differentiated strategies for different groups based on a nuanced understanding of their characteristics, as well as their participation and existing experiences. Indeed, while participants stressed that there is not one answer or solution, they agreed that there are good practices around the world that highlight the possibility of integrating informal workers into social insurance systems and point towards successful approaches to make schemes more accessible, affordable and adequate. It was noted that the question on whether informal workers can be integrated into social insurance systems is not a purely theoretical one, as integration is already happening in many contexts. The real question is how to learn from these experiences and further increase coverage.

Strategies to expand coverage and financing need to recognise the complexity, heterogeneity, context specificity of the informal economy.

It was agreed that an important starting point in efforts to expand the coverage of social insurance is to recognise the diversity of actors within the informal economy, as well as context specificity. Countries' labour markets, income levels and wider social protection systems matter, as does the composition of the informal economy. At a minimum, strategies need to be tailored towards differences in employment status and sectors. Dialogue with relevant stakeholders, including governments, workers and employers, was regarded as key to developing a nuanced understanding required for effective extension strategies.

While many informal workers cannot afford to pay social security contributions, others can at least partially contribute, necessitating nuanced understanding of their incomes, tax obligations and contributory capacities.

Participants agreed that significant segments of informal workers live in or near poverty, and that those generally cannot be expected to contribute the full contribution amount. At the same time, there are many informal economy workers who are not poor and have at least some contributory capacities. The question is how to identify those and where to set the contribution rate to ensure adequacy of benefits, sustainability of schemes and affordability of contributions.

In this, generating nuanced data and careful analysis of informal workers' incomes was seen as essential to understand contributory capacities. This should include analyses of the taxes and fees already paid by informal workers, which are not always accounted for and can add up to a regressive tax-to-income ratio for poorer informal workers, limiting contributory capacities.

Subsidies can be important to making social security contributions affordable for informal workers.

Reflecting on successful experiences in expanding social insurance coverage, participants stressed the importance of ensuring that contributions are affordable. Key strategies of ensuring affordability appear to be subsidies or matching contributions from the government. A question for further debate is whether these subsidies are temporary incentives that should eventually be withdrawn or permanent efforts to ensure affordability.

Important to recognise that many informal workers have an employer, which opens opportunities for coverage gains through the enforcement of labour laws and the potential of financial contributions from employers.

Participants noted that in many contexts there is a significant share of informal workers for which the extension of contributory schemes can be linked to an identifiable employment relationship between an employer and an employee. They might not have a contract, or they might have one that does not pay contributions, but they are in an employee-employer relationship. Where there is an identifiable employment, there is a co-payment possibility, at least in theory, from an employer.

In those contexts, it was seen as a priority to ensure that those employment relationships are recognized, that those workers are recognized as workers, and that employers make commiserate contributions in line with the relevant legislation. Those informally employed in formal enterprises were considered to be amongst the easiest to extend coverage to, as it would be a matter of enforcement of the law. In addition, the importance of supporting the registration of enterprises and employment, working together with employers and workers organisations, was noted.

Social security contributions represent a cost to employers and employees but are generally not a driver of informality.

There was an agreement that labour market outcomes, including participation, sectors and employment status, are the result of a multitude of interacting factors that may include economic structures, individual and household characteristics, as well as the design of tax and benefit systems. The specific nature of such factors, and their interactions, need to be understood in each context to inform effective formalisation, tax and social protection strategies.

There was furthermore an agreement that while social security contributions do represent a cost to workers and employers, simply reducing them will not by itself generate formal employment, which requires addressing relevant economic and structural determinants. Regarding the question whether social security contributions are a key driver of informality, it was agreed that such effects, if they exist, are generally marginal rather than economy wide.

Efforts to expand social security coverage and financing require a systems approach to social protection and labour market policies.

Increases in revenue from social security contributions are intimately linked to the expansion of social security coverage to the informal economy. This means that formalisation strategies and active labour market policies are a key part of efforts to increase social protection financing.

Furthermore, participants noted that the interaction between different parts of social protection systems, in particular between tax-financed social assistance and contributory social security, can affect choices and outcomes. Therefore, it was considered crucial to take a comprehensive system-level view and scrutinise potential interactions between schemes when exploring reforms.

Expansion of social security systems requires a social contract based on trust in institutions, accessible and high-quality benefits.

Participants were united in viewing trust in institutions, including social security agencies but also the government more generally, as central to people's willingness to pay contributions. Contributors need to have trust in the system, being confident that they will receive their benefits, often decades into the future. It was argued that investments in the quality and accessibility of services, as well as the simplification and digitalization of procedures, is key in building trust and demand for social insurance. Finally, it was noted that informal workers are generally ready to pay taxes and contributions, but in return they want to see quality services, and access social protection benefits that suit their needs.

Key points of debate

While there was a consensus that contributory schemes can be expanded to informal workers, there was disagreement regarding the design and financing of these schemes.

Will contributions linked to employment remain feasible?

It was argued that employment-linked schemes are no longer an effective strategy given the changing nature of work (i.e. the decline of stable formal employment).

Others disagreed and made the case that some informal workers are in identifiable employee-employer relationships and there is a possibility for co-payment and the better enforcement of relevant labour and social security laws. They also pointed towards the various global experiences in adapting social insurance schemes to make them more inclusive for those in non-standard employment.

Are standalone schemes for informal workers the best strategy?

Some argued that the most promising strategy to expand contributory schemes to the informal economy is through dedicated schemes for informal workers in the form of flexible and voluntary or mandatory savings schemes.

Others disagreed and argued that a key risk going forward is that we move towards separate schemes for informal workers, which are regarded as 'quick fixes'. It was argued that voluntary individual saving accounts, which is the form that these standalone schemes tend to take, will not provide adequate protection and are not aligned with the international principles on social protection.

Should consumption replace earnings as the base for social security contributions?

Some questioned whether earnings should remain the base of social security contributions, arguing that when social security schemes were initially designed earnings were chosen simply for ease of measurement and access. As consumption becomes more visible (mainly due to technology and electronic payments) it was proposed that earnings may be replaced with consumption as the basis of social security.

There was substantive disagreement with this proposal. Questions were raised whether a consumption-based system would be able to ensure adequate benefit levels and social protection objectives (poverty reduction, consumption smoothing, protection against risks). Furthermore, it was argued that moving towards consumption as the base would relieve employers and more generally owners of capital from their responsibilities in co-financing social protection. Rather than moving away from earnings, for these participants, the key question is how to get employers to continue contributing to social protection despite the changes in the world of work.

Do social security schemes and contributions generate positive social and economic impacts beyond mobilizing resources?

It was argued that social security schemes generate ownership from workers and employers, as they regard schemes as their acquired rights, which is something that may not be replicated by individual schemes or tax-financed ones. A further benefit of social security, it was argued, is that workers and employers together play a role in maintaining benefits and have an interest to ensure good governance, accountability and active participation.

There was some scepticism regarding this claim and some participants questioned whether contribution rates per se have an intrinsic value. Instead, they argued that formalisation does have an intrinsic value, for instance by increasing productivity. Related to this discussion there was an interesting provocation on how to think about subsidized social security contributions and what the objective is to ask for contributions from low earners. Is it to raise funding for social protection systems or about integrating previously excluded people into national systems? From a fiscal perspective, it was argued, many subsidized regimes do not bring in much money, if any. However, this will depend on the scope and degree of subsidisation. Furthermore, aside from fiscal considerations, it was suggested that there may be other benefits to societies, economies, workers and employers to have greater coverage of tax and benefit systems.

While there was a general agreement that the combined effect of taxes and benefits matters, there was disagreement whether this should lead to a greater acceptance of regressive taxation and whether social protection can effectively play the role of compensator.

There was agreement that VATs are generally regressive, disproportionately weighing on low-income households while payroll taxes are usually progressive. It was also generally agreed that at a system level it is the combination of both taxes and benefits that determines overall progressivity.

However, there was a debate on whether this argument should lead to a greater acceptance of regressive forms of taxation. There was further discussion whether in reality social protection

schemes can effectively compensate for regressive tax systems (which would require effective targeting by income), and what the economic and social consequences would be of a tax system that may be fully or in part regressive but achieved full or partial progressivity through social protection.

Some questioned why in times of high and rising inequality we should accept regressivity in taxation at all, even if it can be compensated through social protection. It was asked why we should not ensure that all parts of the tax and benefit system should work to reduce inequality. Others pointed to evidence on the negative effect of VATs on employment and growth. There was also scepticism whether, given the existing evidence on the challenges of poverty-targeting, social protection can realistically be expected to identify the right people or segments of populations to compensate for regressive taxes. Such systems, some thought, could also undermine people's sense of fairness and the social contract.

Others noted that VATs represent a substantive income source for many countries, in particular those with relatively small formal sectors and where, as a result, payroll taxes generate less revenue. Participants making the case for VAT argued that they represent just one of many taxes that should be made use of. Some of those are progressive, like income taxes, and others may be regressive, as VATs generally are. The key is to combine them all to generate sufficient revenues while maintaining overall progressivity with the help from social protection. However, it was also pointed out that social security contributions and income taxes are compliments, not substitutes. If countries are not able to levy social security contributions, they also tend to struggle with personal income taxes, which means they in reality mainly resort to consumption-based ones.

Looking ahead: Possible areas of future research and analysis

A number of the areas of ongoing debate offer opportunities for further research and empirical work towards strengthening shared understanding and potential areas of agreement. These could include:

- The question whether 'contributions linked to employment will remain feasible' could be considered by looking at a country's experiences of adapting social security schemes to their (changing) labour markets. Their successes or shortcomings can tell us something about the adaptability of such schemes to more complex labour markets, today and in the future.
- Context-specific evidence could help us explore answers to the question whether or not 'standalone schemes for informal workers are the best strategy' to expand coverage. Such schemes already exist in some places and can be evaluated in terms of coverage, affordability, protection provided, sustainability and participants' satisfaction. While conceptually maybe more complex, it should also be possible to evaluate the social and economic 'benefits of social security schemes'. Research with workers, employers and governments, for instance, may help explore to what extent social security schemes generate positive outcomes in terms of ownership, governance, shared financing and labour relations.

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- Research could also provide insights to the question of what would happen to social protection systems if consumption replaced earnings as the base for social security contributions. How might such systems look and what kind of protection would they provide? Who would be winners and losers in terms of both cost and benefits of such reforms?
- Finally, we can research the practical consequences of an increased reliance on value added taxes and the ability of social protection to compensate. This can be done theoretically but also empirically, for instance by analysing the incomes and tax ratios of poorer informal households, or by evaluating the willingness and ability of governments to implement compensatory social protection measures. Having data on who is really reached by such measures, their tax-benefit-ratios, as well as perceptions on the fairness of the system, would enable insights into the appropriateness of such revenue mobilisation strategies.

About the USP2030 Financing Working Group

USP2030 is a global partnership for universal social protection to achieve the sustainable development goals. The USP2030 Working Group on Financing was established to facilitate dialogue and the development of shared policy priorities among a diverse range of actors working in social protection financing. This responds to the increased need to address the financing gap to achieve universal social protection. In line with this increased need and focus on financing, the Working Group, open to all partners of USP2030, brings together diverse perspectives to share knowledge and experience, reach and share areas of consensus, and bring focus to areas where continued dialogue is needed. If you are interested in joining the USP2030 partnership or the financing working group please contact financing@usp2030.org