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# The menu of options for financing social protection: System design

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**How are social protection systems financed?** Where does their funding come from? How can financing sources be mobilised? These are some of the many questions addressed in Part II (Systems Design) of the Handbook of Social Protection Systems. (Schüring and Loewe 2021).

Social protection can be funded through various redistributive mechanisms:

Vertical interpersonal redistribution—from affluent people to those in lower socio-economic strata (from the rich to the poor). Vertical redistribution includes financial support from foreign donors.

Horizontal interpersonal redistribution—risk pooling; the mechanism underlying any insurance scheme. It represents a shift in resources between households with similar risks, where those who have not been affected by previously well-described risks (e.g., work accidents) pay compensation to others who have experienced the risk. Horizontal redistribution is financed by advance payments (premiums, contributions) or ex-post payments (e.g., in some informal insurance arrangements and solidarity networks).

Intergenerational redistribution—children and elderly people supported by the working-age population. Parents pay for the needs of their children in all societies. In more traditional settings, children tend to return that investment when parents are no longer able to work. Pay-as-you go pension schemes are also financed in a similar way.

Intertemporal redistribution is the shift in a person's lifetime income from good to bad times; all people finance their own social protection. Contributions are accumulated in individual funds, which are invested in capital markets and later used to finance, for example, pensions, while intertemporal redistribution can range from the present to the future and vice-versa. The former is the underlying mechanism of any savings schemes (whether organised by the State, banks, informal savings associations, or other informal providers) and also of private and some social insurance schemes. The latter entails taking up credit somewhere, to be paid back at a later date.

Social protection financing can also be classified into contributory or non-contributory mechanisms. Contributory financing corresponds to social insurance—one pays a contribution and receives financial compensation when the risk materialises. The advantage of contributory financing is that it is an extra-budgetary revenue, and the funds are used for established objectives, independently from political priorities that might change over time. As the benefits are linked to contributions, subsidies for those with no contributory capacity must be considered. Contributory financing is more suitable for countries with a large formal economy. Often, in low- and middle-income countries with typically large informal economies, only salaried employees working in the public sector and large private corporations have access to formal social insurance.

Non-contributory financing can be mobilised from tax and non-tax revenues: Tax-financing can come from direct (e.g., personal income tax, corporate income tax) or indirect taxes (e.g., value-added taxes). Tax avoidance and largely informal economies are some of the challenges for tax revenues falling short of their potential, especially direct taxes.

Non-tax financing sources stem from profits from public companies and the exploitation of natural resources. In some countries, governments have set up earmarked funds for these revenues. These funds invest their wealth, and the profits accrue to the government. When managed well—i.e., if withdrawals do not exceed profit revenues for instance—the fund can act as a sustainable source of annual revenue. Donor support is part of the non-tax revenues and in many low-income countries, it constitutes the only financing channel for some social protection programmes.

There is no 'one size fits all' strategy for choosing financing mechanisms. Path dependency is a significant determinant and some mechanisms are also more applicable than others in certain circumstances: countries with a largely informal economy and a weak tax collection capacity cannot rely on financing social protection out of direct taxes—at least not as a short- to medium-term strategy. Therefore, low- and middle-income countries tend to rely more on indirect taxes and non-tax revenues.

**Table 1. Strengths and weaknesses of financing methods**

| | Suitable for | Strengths | Weaknesses |
|---|---|---|---|
| Contributory financing | Countries with a large formal sector | Pay-return nexus*<br>Encapsulating the middle class | Narrow tax base |
| | Non-contributory financing tax | | |
| Direct tax | Countries with a large formal sector and a well-organised tax collection administration | Broad tax base<br>Potentially progressive incidence (pro-poor) | Weak pay-return nexus |
| Indirect tax | Countries with a large informal sector moderately organised tax collection administration<br>Paternalistic motive (changing behaviours) | | Weak pay-return nexus<br>Potentially regressive incidence —this can be mitigated when dual-rate structure is applied |

*Source: Van de Meerendonk (2021).*

The Sustainable Development Goals (SDGs) have set a target for social protection 2030 (Target 1.3): "implement nationally appropriate social protection systems and measures for all…. and by 2030 achieve substantial coverage of the poor and the vulnerable". How much financing is needed to meet this target? What are the financing strategies? Chapter 7 of the Handbook provides further guidance regarding financing choices and discusses which of the various instruments are better suited for specific objectives and circumstances.

*References:*

Van de Meerendonk, A. 2021. "Financing". in *Handbook on Social Protection Systems*, edited by E. Schüring and M. Loewe. Cheltenham: Edward Elgar Publishing Limited, 137-149.

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