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Revenue Collection and Social Policies: Their Underestimated Contribution to Social Cohesion

Summary

Social cohesion is an important precondition for peaceful and economically successful societies. The question of how societies hold together and which policies enhance social cohesion has become a relevant topic on both national and international agendas. This Briefing Paper stresses the contribution of revenue collection and social policies, and in particular the interlinkages between the two.

It is evident that revenue mobilisation and social policies are intrinsically intertwined. It is impossible to think carefully about either independently of the other. In particular, revenue is needed to finance more ambitious social policies and allow countries to reach goals, such as those included in the 2030 Agenda for Sustainable Development. Similarly, better social policies can increase the acceptance of higher taxes and fees.

Furthermore, and often underestimated, a better understanding of the interlinkages between revenue generation and social policies can provide a significant contribution to strengthening social cohesion – in particular, concerning state–citizen relationships.

In order to shed light on these interlinkages, it is useful to have a closer look at the concept of the "fiscal contract", which is based on the core idea that governments exchange public services for revenue. Fiscal contracts can be characterised along two dimensions: (i) level of endorsement, that is, the number of actors and groups that at least accept, and ideally proactively support, the fiscal contract, and (ii) level of involvement, that is, the share of the population that is involved as taxpayer, as beneficiary of social policies or both. In many developing countries, either because of incapacity or biased state action towards elite groups, the level of involvement is rather low.

Given the common perception that policies are unjust and inefficient, in many developing countries the level of endorsement is also low. It is precisely in these contexts that interventions on either side of the public budget are crucial and can have a significant societal effect beyond the fiscal realm.

We argue that development programmes need to be especially aware of the potential impacts (negative and positive) that work on revenue collection and social policies can have on the fiscal contract and beyond, and we call on donors and policy-makers alike to recognise these areas as relevant for social cohesion. We specifically identify three key mechanisms connecting social policies and revenue collection through which policy-makers could strengthen the fiscal contract and, thereby, enhance social cohesion:

1. Increasing the effectiveness and/or coverage of public social policies. These interventions could improve the perceptions that people – and not only the direct beneficiaries – have of the state, raising their willingness to pay taxes and, with that, improving revenues.
2. Broadening the tax base. This is likely to generate new revenue that can finance new policies, but more importantly it will increase the level of involvement, which will have other effects, such as increasing government responsiveness and accountability in the use of public resources.
3. Enhancing transparency. This can stimulate public debate and affect people's perceptions of the fiscal system. In order to obtain this result, government campaigns aimed at diffusing information about the main features of policies realised are particularly useful, as are interventions to improve the monitoring and evaluation system.

Introduction

Several international trends, including climate change, demographic change, migration and rising inequality, are putting entire societies under pressure. Both policy-makers and academics have tried to understand the degree of (and the changes in) social cohesion in these societies, as a characteristic that should enable societies to handle these pressures more effectively and peacefully.

Box 1: Defining social cohesion

Despite being a controversial concept, it is possible to identify some key pillars of social cohesion. These are incorporated in the recent DIE definition: Social cohesion refers to both the vertical and the horizontal relations among members of society and the state as characterised by a set of attitudes and norms that includes trust, an inclusive identity and cooperation for the common good.

How can policy-makers enhance social cohesion? This Briefing Paper stresses the role of revenue collection and social policies, and in particular the interlinkages between these two areas, which can be exploited to design social cohesion-enhancing development interventions. In particular, we argue that low levels of citizens' involvement and support for the fiscal contract will translate into a lower level of social cohesion, in particular its dimensions centred around state–citizen relationships.

It is evident that revenue mobilisation and social policies are intrinsically intertwined. It is impossible to think carefully about either of these policy fields independently of the other. Without sufficient domestic revenue, more ambitious social policies that enable countries to reach international goals, such as those included in the 2030 Agenda, cannot be achieved. Donors can help in financing social policies, but these will not be sustainable – neither technically nor politically – if over time the financing of these systems is not based on own-generated revenue. This is especially a problem in sub-Saharan Africa, where social protection schemes are predominantly – and in some cases, almost entirely – financed by donors.

Similarly, it is to be expected that increasing the acceptance of citizens to pay taxes and thereby strengthen revenue collection will hinge upon their perceptions of how much they can expect to get in exchange for their contribution. Hence, the design and content of social policies, as well as the perceptions of whether the benefits and costs are distributed fairly among all taxpayers, are of central relevance.

However, most technical discussions restrict themselves to either the revenue or social policy design questions. This is highly problematical as it hinders the development of an integrated perspective of public financial management along the lines of the concept of good financial governance promoted by the German Federal Ministry of Economic Cooperation and Development (BMZ, 2014). Thus, such discussions overlook detrimental effects on the effectiveness and efficiency of fiscal systems due to interlinkages between social policy and revenue generation. Moreover, this narrow view fails to consider all the far-reaching consequences that decisions in this field have on the social and political realm. In particular, we argue that a better understanding of the interlinkages between revenue mobilisation and social policies can provide a significant contribution to strengthening social cohesion through their impact on the fiscal contract.

The concept of the fiscal contract, in essence, alludes to the common understanding in a society of how much its members can expect to benefit from state action and how much they expect to contribute to it through paying revenue. The degree to which individuals within a society endorse and are involved in the fiscal contract is crucial for social cohesion. Countries with fiscal contracts characterised by high levels of endorsement and involvement will tend to have high levels of social cohesion.

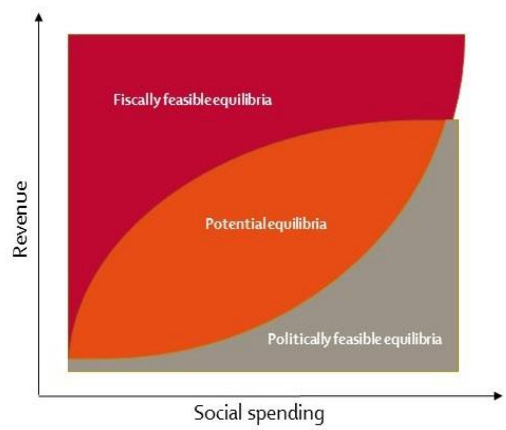
Characterising the fiscal contract

The fiscal contract can be conceived as an equilibrium position in a society with respect to the size and nature of the fiscal system. The fiscal contract implies a level of exchange of revenue for public services between taxpayers and the government. It has an individual and an aggregated dimension, as it will not only influence the aggregate level of revenue and spending, but also who finances and benefits individually from state interventions. Naturally, the net fiscal effect for individuals will vary tremendously in a society. Content-wise, the fiscal contract also varies greatly between countries: countries with a stronger welfare state, for example, usually have their equilibrium at high levels of both revenue and social spending, while others, for instance many developing countries, have a low tax–low social spending equilibrium.

Fiscal contracts reflect political and social power relations in a society, which limit the scope of revenue–social spending equilibriums that are politically feasible at the individual and at the aggregated level (see Figure 1). This also implies that to a certain degree a fiscal contract can be implicit and imposed against the will of some citizens, and that, although they tend to be stable, fiscal contracts can evolve and change over time.

Fiscal contracts at the aggregated level can be characterised along two dimensions. The first is the *level of endorsement*, that is, the number of people and groups that at least accept, and ideally proactively sustain or support, the prevailing fiscal contract. In practice, it is impossible to have a fiscal contract unanimously supported. To what extent a person supports

Figure 1: Fiscal contract as equilibrium



Source: Authors

the fiscal contract depends first of all on their perception of the net fiscal effect on their own living standards. This could also include perceived indirect returns in terms of social stability and peace generated by higher social spending. People, however, may also support the fiscal contract for less "self-interested" reasons: they may care about the conditions of the poor, even though they are not themselves poor.

The second dimension of the fiscal contract is the *level of involvement*, that is, the share of the population that is involved either as tax payer or beneficiary of social policies, or both. Unlike in high-income countries, in developing countries the level of involvement can be quite low: often, many citizens do not have much of a relationship with the state, which tends to be only marginally present in their daily life.

The two dimensions do not necessarily go hand in hand. For example, some societies may not value comprehensive welfare states, which are characterised by a high level of involvement. In this situation, the level of endorsement will decrease at a higher level of involvement.

How social policies and revenue collection can affect the fiscal contract

Fiscal contract theories suggest that the state will be responsive to the interests of those individuals paying taxes by prioritising the spending they favour. Empirical evidence for high and middle-income countries shows that countries which rely predominantly on taxing low and middle-income earners provide more social benefits than states relying more heavily on high-income earners (Timmons, 2005). This empirical evidence underpins the fiscal contract logic that states provide services in exchange for revenue.

The picture is less clear in low-income countries. Social policies are financed less by domestic taxes and more by donors. This blurs the connection between spending and revenue collection. We argue that in these contexts, development interventions on social spending and revenue collection can have a major impact on the fiscal contract by triggering a virtuous cycle that strengthens it.

This virtuous cycle can be initiated from several angles. First, starting from the social policy side, introducing new social policies or expanding and improving already existing ones may improve perceptions of their benefits. In turn, this can increase beneficiaries' willingness to pay taxes and, thus, raise revenue. This may occur also for people that are not directly eligible for social protection programmes, such as cash transfers: in particular, those just above the eligibility criteria may be happy to have a safety net in case their living standards deteriorate. Well-functioning social policies, ideally financed from the public budget – even when targeted at the poor – could be supported, or at least tolerated, by the better-off. This is especially the case when they perceive the importance of reducing inequality and poverty for societal stability, and are aware that they are benefiting from these polices. Expanding social programmes, thus, can increase the level of involvement in the fiscal contract. Furthermore, the protective function of social protection programmes can increase endorsement of the fiscal contract as many non-beneficiaries could potentially benefit from the safety net in times of hardship.

Second, the virtuous cycle can also be started by interventions on the revenue side. Broadening the tax base, meaning increasing the number of taxpayers and reducing the size of the sometimes incredibly large informal sector, can affect social policy and the fiscal contract through two main channels. On the one hand, it will probably lead to an increase in the amount of revenue collected, and thereby increase the potential budget for social policies. On the other hand, a broader tax base increases involvement in the fiscal contract and strengthens government accountability and responsiveness in the use of public resources. Existing literature suggests that taxpayers, by actively contributing to revenue efforts, develop a sense of ownership of public revenue. New taxpayers will hence increase pressure on governments to explain what is done with public money and demand that public budgets better mirror their preferences. This would eventually lead to a higher level of endorsement of the fiscal contract. Earmarking is an extreme option for governments to credibly commit to use resources for services that taxpayers value. It can be an attractive tool, but given the rigidities it generates in the budget and the risks of its political misuse, it should be only used carefully, if at all.

The fiscal contract – in terms of contents and how it is perceived – can also be strongly affected by initiatives focusing on transparency regarding the use of resources and how costs and benefits are distributed among the citizens. This can stimulate public debate and lead to a change in people's perceptions about the performance and the fairness of the system. This requires that public institutions provide more information about the policies implemented, whom they reach, how much they cost and how they are financed. It also entails ensuring adequate monitoring and evaluation capacities, and setting up a transparent procurement system. More transparent and efficient management of the public budget can liberate resources, which could be spent to further strengthen the social policy system or allow a reduction of the tax burden for individual groups or society in general. All of this will contribute to a higher level of endorsement of the fiscal system.

Any intervention supporting the level of endorsement or involvement requires well-functioning state institutions. This is why measures in this area should be closely coordinated with the broader governance agenda to maximise their effect on the fiscal contract and social cohesion.

How the fiscal contract affects social cohesion

It is plausible to expect the mechanisms sketched above to affect dimensions that go well beyond the fiscal realm and enter into the political and social ones. Fiscal contracts that lack endorsement and are imposed against the will of society (or larger groups of it) can increase perceptions of unfairness, weaken the vertical relations between society and the state and thereby undermine social cohesion. By contrast, initiatives that lead to more support of the existing fiscal contract or its reformulation into a more supported one can contribute to developing and strengthening a common identity and mutual trust across individuals and different societal groups. More support indicates a more shared understanding of how members of a society are linked and the degree to which they have rights and responsibilities for each other. In this line, higher endorsement will be connected to better horizontal relations among members of society, as well as more constructive relations between the state and society.

Fiscal contracts with high levels of involvement are also expected to contribute to social cohesion. Expanding the level of involvement will naturally increase interaction in a society and will reach out to people that live independently of the state. This touches upon politically and socially loaded issues, which increase the possibility of confrontation but can also be used as focal points to find compromises and agreements leading to more cohesive societies. Thus, similarly to the effect of increasing endorsement, expanding the level of involvement can facilitate dialogue between groups and the development of a common vision and identity, and create opportunities to bridge trust gaps between societal groups.

Overall, we argue that countries with fiscal contracts characterised by high levels of endorsement and involvement will tend to have high levels of social cohesion. The joint effect of increases in both dimensions should be higher than the individual effect of an increase in one dimension. Assuming that the value for the other dimension remains constant, an increase in endorsement or involvement can be expected to contribute to higher social cohesion.

Conclusion and policy implications

Revenue collection and social policies are interconnected. Especially in developing countries, better revenue collection is a precondition for more ambitious and fiscally sustainable social policies. Similarly, only if a social system performs well, will citizens be willing to contribute to it. The relationship is therefore a cycle that can be virtuous, but often turns out to be vicious.

The strength of these interlinkages is too often underestimated. By affecting the fiscal contract, interventions on social policies and revenue collection have a significant impact on social cohesion. These interlinkages and their impact can be positive and negative but most importantly, they should not be ignored. The key is that revenue generation and social policies are not perceived as a merely technical budgetary matter, and their potential to trigger the development of more cohesive societies is recognised. In this regard, we have highlighted three mechanisms connecting social policies and revenue collection that appear particularly promising for policy-makers to consider.

Concrete measures to activate these mechanisms include:

1. Increasing the effectiveness and/or the coverage of social policies. Higher coverage can be achieved by implementing social policies that are universal and lead to equal opportunities for all.
2. Broadening the tax base. Reducing the number of exemptions is the best place to start. This would also help to reduce the tax system's complexity and the opportunities for corruption associated with discretionary granting of exemptions. More robust implementation of property taxation at the subnational level is another particularly promising avenue.
3. Increasing the adoption of transparent procedures, which can stimulate public debate and influence people's perceptions of the fiscal system. This can be achieved through information campaigns about the policies realised, including their costs and financial sources, or through an improvement of the monitoring and evaluation system.

Donors can and should play a role in enabling the activation of these mechanisms. However, as in the discussion around the broader concept of the social contract (Loewe, Trautner, & Zintl, 2019), it is fundamental that donors are aware of the potential negative consequences that their external interventions can have on the domestic fiscal bargaining processes.

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