relocating rural residents, and even building entirely new cities. The plan simultaneously serves various national objectives: to increase China's percentage of urban residents in line with global developed economy standards, boost domestic consumption to rebalance the economy away from exports, and improve delivery of social services.

Poverty-reduction funds allocated by the central government budget in Xi's first term were more than double the total spending of the previous five years. That money is used primarily for infrastructure, agricultural subsidies, and discounted loans. But spending for another significant poverty-reduction program—a minimum living standard provision called *dibao*—has been declining as a percentage of GDP, according to Ministry of Finance figures.

Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order. The slowdown has led to a pause, even a reversal, in plans to further streamline state-owned enterprises.

"Xi is having none of this business about empowering private interests and 'broadening' the makeup of the Party," Feigenbaum writes. "His team views the unwinding of some of these prior policies as a necessary step toward a new and, from their standpoint, more satisfactory division of roles between the public and private spheres."

Efforts to strengthen the social safety net have also flagged as local officials focus more on restoring growth than goals such as expanding pensions, improving education, or relaxing the *hukou* system, which ties people and their benefits to a particular locale, says Mary Gallagher, a professor of political science at the University of Michigan in Ann Arbor.

"Those things I don't think have been effectively integrated into … the system of performance evaluation for local officials," Gallagher says in an interview.

Other challenges loom. The adoption of new technologies—another national priority for Xi—has put China in a globally competitive position but has also exacerbated its social welfare needs. For instance, China's drive to invest in robotics threatens to cause large-scale unemployment in industries, from logistics to manufacturing, that provided lifelong jobs in the past. Displacement of many more workers could sow discontent should China renew efforts to streamline state enterprises, throwing workers into national benefit plans that are often less generous than those provided by employers.

"A lot of times, when they do close down these firms, they'll say you'll still have a job, but it might be as a street sweeper," Elizabeth Economy, director for Asia Studies at the New York–based Council on Foreign Relations, says in an interview. "There's a huge difference in the type of work they are getting and the type of benefits."

Xi's acknowledgment of economic shortcomings and his blueprint for solutions raise the stakes for his government when priorities fall short of expectations, Economy says.

"Economic reform, poverty alleviation, addressing environmental issues—all of those things are policy initiatives that he thinks are essential to maintaining the legitimacy of the Communist Party and moving the country forward," she says.

But the biggest test facing Xi's government may be an unavoidable demographic trend—the widening gap between pension contributions and payouts as China's population grows older.

Given the economic slowdown, Xi's goal of ending rural poverty by 2020 will be a tall order.

The State Council, or cabinet, predicts about a quarter of the population will be over 60 by 2030. Estimates of the country's pension funding shortfall within the next few years range from $130 billion to $175 billion, a gap the government must fill. While Xi has vowed to improve the system, his administration has offered few specifics. Last year, the government directed a handful of large state-owned companies to transfer 10 percent of their stock to pension funds to ease the funds' asset shortfall. And the government took steps this year to remove regional disparities in benefits. One option could be to tap into the government's healthy coffers, making contributions from general revenues.

Other options—none of them easy—would focus on investing funds more effectively to boost returns; cutting benefits, which would risk alienating pensioners; or raising contribution rates for companies and individuals, which are high compared with other countries. Already running behind the rising expectations of ordinary Chinese people, the government must race just to catch up. FD

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CREATING FISCAL SPACE

Enhancing domestic tax capacity is essential for strengthening social protection and developing human capital

David Coady

A key challenge for developing economies wishing to strengthen their social protection systems and expand access to education and health is how to raise the necessary revenue in the context of a large informal sector.

The informal sector is typically characterized by high levels of self-employment, low skill levels, and often multiple and volatile sources of income. This limits the potential to raise revenue by taxing income—especially from lower-income groups—which requires the ability to verify total individual income. In the context of social insurance, it also means greater reliance on financing through general government revenue sources than on the contributory models emphasized in advanced economies (see "Shifting Tides" and "Reimagining Social Protection," in this issue of *F&D*).

Recent research also finds that countries move to a higher growth path once tax revenue reaches about 15 percent of GDP (Gaspar, Jaramillo, and Wingender 2016), in part reflecting higher social spending. However, about half of low-income countries—and a third of emerging market economies—have tax ratios below this 15 percent threshold. Low tax ratios in turn result in low levels of social spending (see Chart 1).

ART: ISTOCK / BEASTFROMEAST; ALFEXE

This large variation in tax ratios within emerging market and low-income countries suggests that many have ample room for higher taxation. Some have succeeded in increasing their tax ratios in recent years, sustainably increasing tax revenues to bring them close to or above 15 percent of GDP. Georgia is a leader in this group, having increased tax revenue by 12.9 percent of GDP during 2004–08. Maldives raised revenue by 11 percent of GDP during 2011–15. Others that have made significant gains over similar periods include Dominica (7.5 percent, 2002–06), Ghana (7.3 percent, 2000–04), Mauritania (6.1 percent, 2010–14), Mozambique (6.1 percent, 2007–11), Guinea (5.8 percent, 2008–12), Malawi (5.7 percent, 2003–07), and Cambodia (5.0 percent, 2012–16).

Countries move to a higher growth path once tax revenue reaches about 15 percent of GDP.

These countries show what's possible. But how can governments increase their tax capacity both equitably and efficiently?

As countries modernize their tax systems, they typically expand broad-based consumption taxes and selective excise taxes and prioritize the development of progressive income tax systems (see Chart 2).

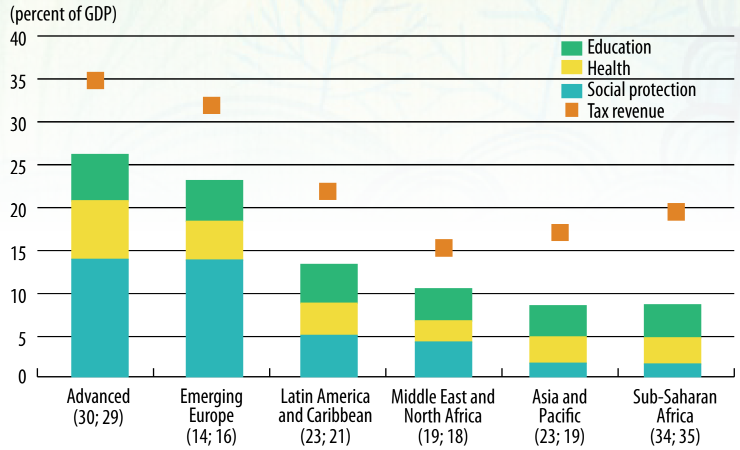
Broad-based consumption taxes: Increased revenue from consumption taxes, especially value-added tax (VAT), has been the main driver for most countries that have managed to significantly increase their tax ratios over recent decades.

Greater reliance on excise taxes: "Corrective" taxes on such goods as energy, alcohol, tobacco, and (somewhat more contentiously) sugar-sweetened beverages—levied on top of the normal VAT—can be an efficient source of revenue and help reduce the negative health impacts associated with their consumption. Along with consumption taxes, excise taxes provide an administratively feasible way of increasing revenues over the short term.

Chart 1

Financing development

Low tax revenue results in low levels of social spending. Raising revenue could thus help countries move to a higher growth path.

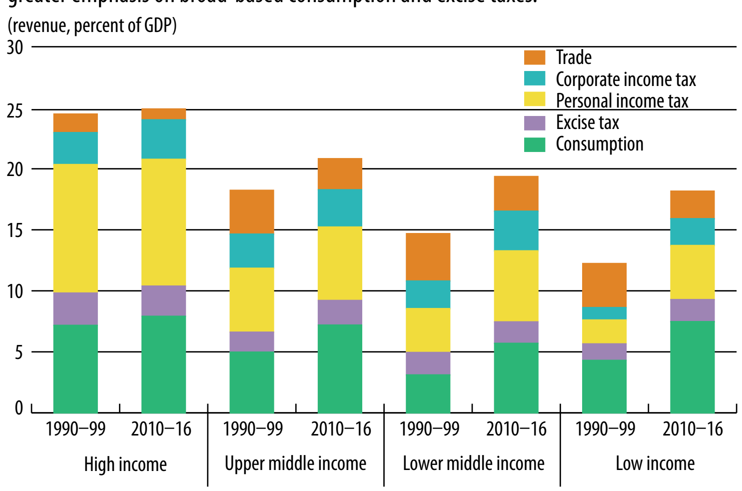


Source: International Monetary Fund WoRLD Data set.
Note: The sample size refers to the number of countries in the spending sample, then revenue.

Chart 2

Tax levels and composition

The composition of taxes in richer countries differs from that of poorer countries, with greater emphasis on broad-based consumption and excise taxes.



Source: International Monetary Fund WoRLD Data set.

Progressive personal income taxes: The development of a such a system has been an important source of revenue for advanced economies and a key component of efficient systems for redistribution of income. However, high levels of tax exemption or tax evasion in emerging market and developing economies limit the short-term potential for such revenue. Even so, experience shows that countries can still raise sizable additional revenue through stronger personal income tax systems.

Additional tax measures: Other measures can be employed to protect and further expand tax sources. These include reforms to address corporate income tax avoidance and reduce mutually destructive international tax competition, but these may also need stronger international cooperation to be effective. Average effective corporate tax rates have declined significantly over recent decades across the globe and are typically lower than statutory rates due to exemptions, deductions, and tax planning. Recent estimates put the long-term costs from profit shifting to lower-tax countries at about 1 to 1.5 percent of GDP for developing economies (Crivelli, de Mooij, and Keen 2016).

Removing tax incentives, such as tax-free zones, exemptions, and tax holidays, can lead to sizable revenue gains. There is also room in most emerging market and developing economies to expand revenue from property taxes, an efficient and equitable source of revenue, but with relatively modest potential. Finally, in many countries, natural resource revenue is an equitable and efficient revenue source that is often inadequately tapped.

Policy and institutional reforms must go hand in hand. For example, as administrative capacity is strengthened, VAT and income tax thresholds can be lowered. Risk-based tax audit systems can help enhance compliance and tax fairness. In the context of the VAT, the potential for such revenue gains can be explored though the concept of C-efficiency—defined as the ratio of actual revenue to potential revenue when all consumption is taxed at the standard rate in a country. C-efficiency measures how close a government comes to collecting tax on all consumption in the economy. The revenue potential from increasing this ratio is substantial. In practice, the rise in VAT revenue in recent decades has been driven primarily by improvements in C-efficiency rather than by increasing tax rates (Keen 2013).

Improved spending efficiency: There is large variation in social outcomes across countries with similar spending levels, suggesting substantial room to improve spending efficiency. This is essential to ensure that additional revenue is not wasted. All spending items need to be scrutinized to ensure that they are achieving their economic and social objectives. Estimates of spending inefficiencies in the health care sector suggest that as much as 40 percent of spending may be wasted across all country income groups. Many countries spend significant amounts on inefficient and inequitable energy subsidies aimed at protecting domestic consumers from volatile international oil prices. A key barrier to reforming these subsidies is the absence of a strong safety net to adequately protect the poor from rising energy prices.

There is large variation in social outcomes across countries with similar spending levels, suggesting substantial room to improve spending efficiency.

While broad-based consumption and selective excise taxes are efficient sources of revenue, it is important to ensure that countries have access to strong safety nets that adequately protect the poor and vulnerable from associated price increases. Absent such protection, harm to the poor can be mitigated through a higher VAT registration threshold, which determines when a firm is large enough, based on sales, to be required to charge VAT. Another possibility is reducing the VAT rate for goods consumed disproportionately by the poor. Excise tax increases can also focus first on goods consumed disproportionately by higher-income households, such as gasoline and high-end alcohol, and possibly tobacco. A gradual reform process that phases in and sequences tax