increases across products allows for some of the revenue gains to be allocated to strengthening safety nets over the short term, thus allowing poor and vulnerable households to be adequately protected from more comprehensive reforms over the medium term.

Strategies for strengthening tax capacity should be framed within a broader process that involves all of government (line ministries and the Ministry of Finance), citizen participation, and good governance. It is essential to embed tax reform plans within national development plans that identify priority spending needs, which are often anchored in national strategies for attaining the United Nations Sustainable Development Goals. Effective consultation on, and communication of, comprehensive spending and tax plans to strengthen the social contract with civil society is necessary as well. This could lead to adoption of a consensus-based medium-term revenue strategy, as described in the Platform for Collaboration on Tax (IMF and others 2016). (Nobody votes for a tax hike in isolation!)

Equally important is the need for transparent and effective public financial management systems that ensure and demonstrate that tax revenues are spent efficiently and not wasted or fraudulently used. FD

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Night scene at Malioboro Street in Yogyakarta, Indonesia.

Targeting THE POOR

Developing economies face special challenges in delivering social protection

Rema Hanna, Adnan Khan, and Benjamin Olken

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Many people believe that social protection generally involves rich countries aiding those that are poor. Aid is important, particularly for extremely poor countries. Bad shocks can quickly devolve into humanitarian disasters and promote conflict in fragile states, as seen with the current famine in South Sudan, the incipient famine and cholera in Yemen, and the recent Ebola outbreak in Guinea, Liberia, and Sierra Leone.

But for the 108 countries the World Bank classifies as "upper-middle" or "lower-middle" income—for example, India, Morocco, and Peru—overall tax revenue now dwarfs development assistance. Given that growth has been accompanied by increases in global inequality, it is not surprising that redistribution is increasingly taking place within countries. In these environments external support is often important during initial program design and launch, but social protection can be funded primarily through domestic sources in the long run.

As many of these countries increasingly initiate redistribution within their own borders, they are facing challenges different from those in high-income countries. Understanding these differences is critical to grasping how social protection has evolved over time, and how it may change in the future.

In-kind subsidies

The traditional way of providing transfers in many countries, and one that is still common today, is to subsidize particular products. Staple foods are one classic example. Energy is another.

The rationale for this policy tool is simple. In developed economies, the government can use income information from tax documents and other sources to identify who needs assistance. In less developed settings, however, substantial activity occurs in the informal sector, particularly among the poor. There is no paper trail of who is employed and how much they earn—at least none that can be easily verified. Instead, governments aim to subsidize products the poor use disproportionately so that they get a larger portion of the subsidy.

Subsidies tend to be politically popular for several reasons. The first is transparency; for example, with an energy subsidy, consumers see the subsidized price at the pump. A second is that since everyone benefits from subsidies, they may enjoy broader political support than programs that benefit only the poor. Finally, governments can claim that they influence what people consume; for example, subsidizing eggs or milk to ensure that kids get enough protein, rather than a cash subsidy the poor might waste on so-called temptation goods such as alcohol or tobacco.

These arguments have not always been borne out in practice. For the poor to receive more of the subsidy calls for subsidization of what economists call "inferior goods," goods whose demand decreases as people get richer—cassava when everyone prefers rice, low-quality food, and so forth. Subsidizing inferior goods is often unpopular; instead, most subsidies end up being for everyday goods—things people buy more of as they have more income. This

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undermines redistribution, as these programs end up benefiting mostly the middle class, or even the rich.

Picking up the tab for more popular goods also makes subsidies expensive. Energy subsidies are a classic example. Since everyone can access the subsidy, it must be quite large in order to ensure that the poor get a reasonable share, and in most cases many of the benefits accrue to the middle class, not the poor. In fact, spending is already so high for these subsidies that the amount governments would save by eliminating energy subsidies in emerging market and developing economies exceeds what many of them spend on public health.

Subsidies also have distortionary consequences. Energy subsidies, for example, have serious environmental ramifications. Subsidizing particular foods, such as rice, can backfire in terms of achieving balanced nutrition. And the idea that the poor waste cash by spending it largely on so-called temptation goods has been debunked many times, undermining much of the rationale for trying to influence what people spend the money on in the first place.

Given the cost and distortionary consequences of blanket subsidies, many countries fix the quantity of subsidized goods each household can receive, and potentially restrict them to poor households. This, however, introduces a host of other challenges, such as building a bureaucracy to distribute the goods and monitor who receives them and how much. These systems are generally subject to significant corruption and leakage, given the challenges in managing them.

Reaching the right households

For these reasons, developing economies are moving away from universal (or limited) in-kind subsidies and transfers to the poor and toward targeted cash transfers of various types. Cash is neutral and thus does not distort what people purchase. Moreover, evidence suggests that the labor-supply consequences of cash transfers are small—that is, these programs do not seem to discourage work, often a concern when it comes to transfer programs. Finally, as an additional benefit, cash transfers can be used as a fiscal stimulus to smooth negative macroeconomic shocks by distributing money directly to poor households that have a high marginal propensity to consume.

Targeted cash transfer programs are already widespread in developed economies. For example, the United States provides poor working families with cash through the Earned Income Tax Credit. The US government can do this because the tax system makes it possible to verify which households are poor, and the formal banking system has effective mechanisms to ensure that the poor receive the transfers.

In contrast, many developing economies face challenges in both targeting and distribution. The informality of the workforce means that few people are captured by the tax system, so it is hard to verify income. And many households remain unbanked, so transferring funds to them is logistically difficult.

These challenges are daunting, but developing economies are finding ways to overcome them.

First, there are alternate methods to target transfers to the poor. A common approach is the "proxy means test." Governments predict income using data from periodic, large-scale quasi censuses of the population that collect information on easy-to-verify assets (such as the material of a household's roof and floor) and demographics. Households with a predicted income below a given threshold receive benefits for a set period of time (for example, until the next census is conducted).

These methods can be quite effective at achieving redistribution. For example, in recent work, we compared what would happen if transfers went to those deemed eligible based on the proxy means test compared with what would happen if the same budget were simply divided equally among everyone (via a universal cash transfer, also known as universal basic income) for two programs in Indonesia and Peru.

Even though targeting through proxy means testing has its flaws, we find that it yields higher overall welfare than the universal transfer, because means testing concentrates benefits among the poor. Put another way, per-beneficiary transfers would have to be much smaller for universal programs than for targeted transfers, usually because of overall budget constraints and competing priorities for government spending (for example, infrastructure development, education, and so forth). In fact, only in the case of significant targeting error would the universal transfer come out ahead.

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