

## **Social Value Added Tax as a reform for Social Security financing: Empirical Literature review and lessons for Tunisia**

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### **Abstract**

Introducing a Social Value Added Tax can be a good solution to revive economic activity and consequently promote positive environment proper to finance social security funds. However, we should not expect a magic solution to unemployment, external deficit and social security system's deficits. According to empirical researches and international experiences, the effects of such policy are complex. The anti-redistributive impact should be taken seriously: this "social" VAT could prove to be "anti-social". With this uncertainty, the implementation of Social VAT in Tunisia's present conditions would be too risky given the social inequalities that already prevail in Tunisia.

**Keywords:** Inequality; social Value-added tax; social programs, fiscal incidence, pension system

**JEL categories:** H31; H32, H55, J26, O17

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## **Introduction**

Resources of social security schemes are known to depend on economic growth and formal employment levels. A positive socioeconomic environment could largely mitigate the deficits of social security system. It is in the pursuit of promoting employment, competitiveness and economic growth, through introducing Social Value Added Tax (Social VAT), that the concept found its way into the debate on social security reforms. This proposal integrates itself into a more general taxation framework on financing social security schemes.

The aim of Social VAT is to increase tax rates on the Value added while reducing employers' social insurance contributions, ( i.e. payroll taxes used to finance social security programs), (Rebière (2013), Bernard& Vielle (2006)) . The term "social" is confusing: it is not a measure in favor of the lower income classes, but it denotes financing a portion of social security benefits, which gives it its social character.

According to proponents of Social Value Added Tax, this measure would, under some conditions, promote adjustments conducive to employment creation, increasing competitiveness and economic growth (Bassilière & al(2005), Besson (2007), Benard & al (2006), Bernard & Vielle (2006)). Moreover, in addition to reviving economic activity, crucial to finance social security system, the latter could benefit from a reduction in informal employment and tax evasion (Aureo & Scheinkman (2009) and Boadway & Motohiro (2009)).

Such a reform has fuelled political and economic debates. Different reports and studies, questioning such a policy opportunities, have argued against Social VAT (Desai & Hines (2005), Fève & al (2010)) .

Introducing Social VAT raises the concern about the different socio-economic stakes:

-the macroeconomic stakes on the expected effects on growth through decreasing labor costs and possible inflation and gains in competitiveness,

- stakes on social security financing which would highly depend on socio-economic impacts,

- social issues related to the redistributive or anti-redistributive nature of Social VAT and the risk of an increase in inequalities.

Because of the complexity of the involved mechanisms, a full assessment of social taxation impact requires an analysis that takes into account the different interacting economic factors, at an international level. It is therefore necessary to quantify the impact of the main mechanisms at work and to assess the extent to which they combine in order to achieve the fixed objectives.

Referring to empirical researches and international experiences, this paper aims to put in exergue the opportunities of introducing a Social Value Added Tax in Tunisia, by examining the impacts to be expected on economic efficiency and on the winners and losers of implementing this policy.

In the next section, we present the macroeconomic stakes of Social VAT. In the third section, we discuss the effects of Social VAT on social security financing and anti-redistributive stakes. In a fourth section, we present the estimated overall impact according to empirical studies. In a Fifth section, we synthesize international experiences for Social VAT implementation. Finally, the last section summarizes the main findings and presents the conclusions.

## **I. The macroeconomic stakes of Social VAT**

Macroeconomic stakes can be determined by the effects on employment, competitiveness and inflation.

## **II-1 Effects on employment**

Tax wedge, defined as the difference between the gross wage paid by the employer and the net wage received by the employee, weighs on labor cost. Social VAT would likely have a positive effect on employment through lower labor costs resulting from decreasing employers' social security contributions. International empirical evidence estimates that a reduction in tax wedge could lead to an increase in formal employment. The extent of the effect highly depends on labor supply elasticity compared to labor cost. The expected impact is all the more important as this elasticity stretches up. It also depends on the workforce nature, skilled or unskilled labor (Bchir & al (2012), Bchir & Rajhi (2011), Böhringer & al (2005), Holmlund & Kolm.A.S (1995), OECD (2007)).

## **II-2- Effects on competitiveness**

The transfer of employers' social security contributions to social VAT can be interpreted as a fiscal devaluation that would allow local companies to improve their price competitiveness (provided that other commercial partners do not adopt a similar policy). Indeed, Social VAT is applied to all goods and services sold domestically (manufactured locally or imported), and not to exports. Therefore, according to some studies (Lagadec & Ris (2010), Desai & Hines (2005), Keen & Syed (2006)), it could contribute to:

-improve the competitiveness of national export industries by lowering selling prices excluding VAT as a result of lower social contributions. Different quantification of this effect indicates that it would not necessarily be important if non-price factors were included in the analysis.

- improve the competitiveness of domestic industry within the domestic market by increasing prices, including VAT, for imported products. According to empirical research, this effect

largely depends on the variation in the prices of domestically-produced products and the degree of substitutability of local products with foreign products.

### **II-3 Effects on inflation**

Introducing Social VAT would have the effect of increasing product prices, which could cripple consumption and therefore growth and employment. These negative effects could be mitigated if firms reduce pre-tax price as lower labor costs improve their profit margins. Empirical simulations show that intensity of inflation effect will depend on firms' behavior and the competitive structure of markets (Lagadec & Ris (2010) and Gautier & Lalliard (2014)).

## **II. The effects of Social VAT on social security financing and anti-redistributive stakes**

Assuming that decreasing social security contributions is compensated by an increase in Social VAT, empirical research shows that additional resources for social security financing could result from possible positive effects. These effects follow from an increase in employment, competitiveness and economic growth as well as a decrease in informal employment and tax evasion, as tax wedge is considered, in particular by small companies, an obstacle to formalization (Aureo & Scheinkman (2009), Boadway & Motohiro (2009) ). Nevertheless, these effects do not reduce the need for a high social security financing scheme. Other studies pointed out that a significant decrease in the deficits of social security system could only take place by raising Social VAT higher than would be required by a strict compensation for reducing social security contributions.

In regards to distributional effects, different studies, Courtioux (2007), Caspersen & Metcalf (1994), Metcalf (1994), using various micro-simulation scenarios, show that Social VAT

would increase inequalities between taxpayers, thus undermining fiscal equity. Introducing Social VAT could reduce households' purchasing power if companies do not plot reductions in social security contributions on their prices. Low-income consumers would be the most affected, as this measure affects all consumers in the same way without taking into account income level, leading to an increase in inequality. In this case, redistribution favors companies. For example, a micro-simulation analysis in France highlighted the strong heterogeneity of the impact of introducing Social VAT that respects households' socio-demographic characteristics. The results concluded to, among other things, an increase in inequalities in living standards.

### **III. Estimated overall impact**

Previous researches, Benard & al(2006), Bird & Smart (2012), Fève & al (2010), Gauthier.S (2009), Laffargue (2000), Maarek (2008), Remy (2005), Sénat (2005), show that introducing Social VAT generates opposite impacts which may take either directions. In the context of economic policy, an overall impact assessment is needed to decide whether or not to implement such a policy. According to research, the results are very variable in quantifying its effect. They highly depend on the initial conditions, the accompanying policies and different elasticities values reflecting the intensity of variable modification. From an economic point of view, a certain average effect is difficult to measure. Some studies, in favor of Social VAT, conclude that positive effects on employment, productivity gains and wage negotiations could mitigate the anti-redistributive effects. Other studies against such a measure call into question the expected benefits of Social VAT by arguing that inflation-indexed wages or wage negotiations could cancel the initial effect of reducing labor cost and therefore conclude to the inefficacy of Social VAT. In conclusion, the social and economic effects of Social VAT are therefore quite random and uncertain.

#### **IV. International Experiences: Relative Effects**

International experiences, limited in number, are not convincing with regard to encouraging the introduction of Social VAT. Its effects should depend on the characteristics of each country, the economic context during the implementation of the reform and the accompanying policies:

- In 1987, the Danish experience (Marini.P(2004)) consisted in introducing a social VAT of three points (VAT increases from 22 to 25%) with the quasi suppression of social security contributions paid by employers. This measure is only one element among others in the Danish reform. Indeed, accompanying policies have been adopted, in particular the launching of a global policy for competitiveness and ensuring the commitment of trade unions to moderate wage increase in the years following the reform. The overall impact was positive: a drop in unemployment, a relatively limited inflation impact and an improvement in competitiveness (balance of payments became positive again in 1990, for the first time in more than 20 years). The anti-redistributive character of Social VAT has been corrected by the very high progressivity of direct taxation (Lockwood & al (2000)), a typical feature of the Danish social model. Overall, the experience was successful.

- The Murayama reform implemented in 1997 in Japan proved to be disastrous. Indeed, in a fragile economic context, the two-point increase (from 3% to 5%) in Social VAT seems to have had a depressive effect: in the months following the reform, consumption declined by 13.3%; GDP dropped by 2%. The negative impact on the economy was estimated at 10300 billion yen, of which 4100 billion was caused a decline in consumption. A study published in 2012 (Cashin & Takashi (2012)) confirmed that the economic slowdown in Japan was triggered by a tax increase in April 1997. The results suggest, inter alia, that a gradual

increase in tax would have avoided the large economic fluctuations and the associated anti-redistributive effects.

-In Germany (Schmähl (1998)), tax was increased by 3% (from 16 to 19%) in order to finance a portion of the 6.5% to 4.2% reductions in unemployment contributions. Reduction in unemployment and gains in economic growth were significant, economy's competitiveness improved, inflation rate increased by 1%, consumption fell by 0.2% in average in 2007. However, unlike the Danish case, Social VAT in Germany is only partially social. Social protection benefited by only 1% from the increase in tax, the others two points were used to reduce public debt. As of 2008, two points are used to finance social security funds and one point to reduce debt.

- France abandoned the introduction of Social Value Added Tax. Indeed, after a long debate (Besson (2007), Benard al (2006), Rebière (2013), ) putting forward mixed results on the effects of this policy, public authorities decided to cancel the project. This policy is deemed to be not suitable for France. Indeed, taxing household consumption would not have a significant impact on imports, imports would only be marginally affected, the positive effect on employment is not certain. Some studies found a zero effect on long-term employment and even a slight decrease in GDP (because of the negative shock on demand) and financial deficits of social security funds would not be totally eliminated.

## **V. Conclusion**

Introducing Social VAT could be a good solution to revive economic activity and consequently promote a positive environment proper to finance social security funds. However, the magic solution to unemployment, external deficit and social security system's deficits cannot be expected. According to empirical research and international experiences,



the effects of such a policy are more complex than initially foreseen. The simulated or observed results fail to determine accurately what would be the overall impact and its extent. Besides this imprecision in measurement, the effects would vary across the different sectors of the economy and the different households. The anti-redistributive impact should be taken seriously: this "social" VAT could prove to be "anti-social". On the one hand, it finances fiscal advantages reserved for few persons by draining the rest of the population. On the other hand, a great inflationary risk underlines this measure.

In Tunisia, robust studies on the issue are very rare. Even the ESCWA report on the Arab region published in 2012 is not credible enough: According to this report, introducing Social VAT, just necessary to compensate for 50% decrease in social security contributions, would have a positive effect on employment in Tunisia (following a 4.4% increase in tax). However, this would not be the case for Bahrain, even though a decrease in labor costs would be greater than for Tunisia.

In conclusion, and with the uncertainty around the introduction of Social Value Added Tax, the implementation of such a policy in Tunisia's present conditions would be too risky given the social inequalities that already prevail in our country.

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