



Strategies to Reduce Contribution Evasion in Social Security Financing

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Summary. — Contribution evasion is a serious problem for social security financing in many countries. A mixture of strategies may be most effective in reducing the underpayment and nonpayment of mandatory social security contributions by employers and workers. Contribution evasion can be reduced by changes in: (a) the incentives inherent in the design of social security systems, (b) employer, worker and governmental attitudes toward compliance, (c) administrative procedures that improve the efficiency of contribution collection by government or reduce the cost to workers and employers of compliance, and (d) macroeconomic policies that maintain low inflation and provide for low unemployment with stable growth. © 2001 Elsevier Science Ltd. All rights reserved.

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1. INTRODUCTION

Contribution evasion occurs when employees and employers do not pay or underpay required social security contributions. It is a critical problem for social security programs in much of Central and Eastern Europe, Latin America, Africa and Asia. In some countries in Latin America and Central Asia, it has caused social security revenue to fall far short of that needed to pay benefits.

Employers use a number of strategies to evade contributions. They fail to register some or all of their employees, they hire workers informally rather than as part of the official payroll, they claim workers are contractors rather than employees, or they fail to pay required contributions for their registered employees. Employers also underpay contributions and make late payments. Employees may be unaware of contribution evasion, as there is no way for them to check the contributions paid by employers on their behalf. Contribution evasion also occurs due to

workers failing to make required contributions. It occurs by governments in some countries, failing to make required social security contributions for their employees. In some countries, public enterprises are the worst offenders because they are in the worst financial condition.

Contribution avoidance is a closely related problem. It occurs when employers and workers change their behavior to avoid being liable legally for social security contributions. It occurs when workers take jobs not covered by social security. It occurs due to employers structuring work and payment so that the people who work for them are not be classified

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as employees. In countries where employers are not required to cover their workers if they employ less than a fixed number, small employers may hire fewer employees for more hours to avoid being required to make social security contributions. Contribution avoidance occurs by employers structuring compensation to reduce the part of compensation that is covered by social security. This restructuring of compensation can be done by small enterprise owners when they take compensation as profits rather than as wages. It can be done by increasing the nontaxable part of compensation—such as, in some enterprises, by paying compensation in the form of employer contributions to occupational pensions.

Contribution evasion has several undesirable effects. It causes inequities in effective contribution and tax rates between contributors and noncontributors, possibly increasing the inequality of income distribution among otherwise similar workers. It causes the contribution rates required to produce adequate benefits to be higher than they would need to be, although the increase in the mandatory contribution rate may occur with a long time lag causing an intervening period of revenue shortfall. Contribution avoidance and contribution evasion may distort labor market activity, which has attendant welfare costs. The shift of workers to the underground economy or the informal sector may reduce economic growth. The informal sector has grown considerably in Africa and South America, which has reduced the tax base. This labor market development may have occurred in part to avoid paying taxes and mandatory contributions. When evasion occurs due to underreporting of earnings, it causes the replacement rate with respect to actual earnings to be reduced. Underreporting of earnings occurs in Egypt, resulting in low benefits in a system designed to provide generous benefits. In Turkey, evasion due to underreporting of earnings is so great that it fundamentally distorts the benefit structure, changing an earnings-related benefit structure into one that is nearly flat.

Mandatory payments by employees and employers to finance social security benefits are called “taxes” by some policy analysts and “contributions” by others. We use the term “contributions” to indicate that the benefits employees receive are related to payments made by them or on their behalf. That relationship between contributions and benefits occurs when both benefits and contributions

are based on the employee’s earnings. Contributions imply a right to a future benefit. A tax, by contrast, finances the general functioning of government, but the government-provided benefits the individual receives do not depend on the amount of taxes he or she pays.

Tax evasion has been analyzed by Cowell (1990), Tanzi (1999), and others and the literature has been surveyed by Alm (1996). The issues concerning social security contribution evasion differ somewhat from those concerning tax evasion because social security is generally financed using an ear-marked tax, where the tax or contributions are specifically designated for the purpose of financing social security benefits. Manchester (1999) discusses economic effects of social security contribution evasion, while Gillion, Turner, Bailey, and Latulippe (2000) discuss its causes, and Rofman and Demarco (1999) discuss the merits of centralized contribution collection as an administrative solution to contribution evasion. Contribution evasion is one aspect of a more general problem that in some countries many workers do not participate in formal social security programs. That problem is discussed in Gillion *et al.* (2000).

As in the previous analyses of social security contribution evasion, we focus here on contributions for social security pensions. We first briefly discuss reasons why contribution evasion occurs. We then focus on strategies to reduce contribution evasion. We argue that, rather than focusing solely on the structure of social security contributions and benefits, a mixture of strategies may be most effective in reducing contribution evasion.

2. WHY DOES CONTRIBUTION EVASION OCCUR?

Contribution evasion involves employers, employees, and the government. Its prevalence depends on the attitudes of each and on the cost and reward structure they face. Both employers and employees have incentives to contribute as well as incentives to evade, and the incentives for each group can be examined separately. The actual prevalence of contribution evasion, however, depends on interactions between incentives and actions of employers and those of employees, and the interaction of both with government enforcement.

In most social security schemes, employers are legally obligated to pay social security

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