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
contributions on behalf of employees, also withholding employee contributions from pay. Thus, opportunities to evade for workers wishing to do so are limited to collusion with employers and to changing their employment to become self-employed, casual, or contract workers, where required contributions are more easily evaded.

In some countries, social security contributions are collected with income taxes and it is impossible to pay one without paying the other. In that circumstance, the decision to evade social security contributions must be considered with the evasion of income tax payments. In other countries for all workers, and in yet other countries for some workers, the payment of the two is separated.

Contribution evasion must generally involve collusion between employers and employees. Often, the interests of employers and employees are aligned, with both reducing their immediate expenses by evading contributions. Because employers are legally obligated either to make payments on behalf of their employees or to collect contributions from their employees, when evasion occurs and employees are aware of it, the employees could report this to the social security institution enforcement office. Exceptions to the rule that contribution evasion is the result of employer–employee collusion occur for self-employed workers (who have no employer) and in the case of employer embezzlement of employee contributions (collecting them but not remitting them to the government), when the employee would not consent to and may not be aware of the evasion. Employees may only become aware of contribution evasion when they or a coworker make a claim for social security benefits.

When workers also wish to avoid contributing, collusion is easily established. In that situation, employers evading contributions will have an advantage in labor markets because the compensation package they offer, which does not involve social security contributions, is more desirable than the compensation package offered by nonevading employers. Thus, in some instances the motivations of employees may be a key factor in determining evasion.

However, if employees wish to contribute in a system where employer contributions are also required, the employer presumably must offer them higher wages to offset the disadvantage of working for an evading employer. To some extent sorting occurs in the labor market, so that employees that most wish to evade contributions work for employers that also most wish to evade contributions.

In sum, the reasons for contribution evasion can be divided into those affecting employees’ willingness to pay or reluctance to report nonpayment to authorities and those affecting employers’ motivations. A further factor is the government’s attitude toward evasion. For contribution evasion to occur, and more generally for violations of laws protecting workers in the workplace to occur, three conditions are required: (a) employees must prefer nonpayment of contributions or be reluctant to report nonpayment to government authorities, (b) employers must wish to evade or place a low priority on making social security contributions relative to other expenses, and (c) government enforcement must tolerate evasion or be inadequate to prevent it.

3. POLICIES TO REDUCE CONTRIBUTION EVASION

A mixture of strategies may be most effective in reducing contribution evasion. Possible strategies include changes in: the incentives inherent in the structure of social security systems; employer, worker and government attitudes toward compliance; administrative procedures that improve the efficiency of contribution collection or reduce the cost to workers and employers of compliance (the compliance burden); and macroeconomic policies that provide more favorable economic conditions for workers and employers to make contributions.

(a) Changes in the structure of social security

Incentives inherent in the structure of social security systems may contribute to contribution evasion.

(i) Reducing security contribution rates

In countries with poor compliance with social security contribution payments, the mandatory social security contribution rate is often high. The high rate is both a cause and a result of poor compliance. It is an inducement to avoid paying contributions. It creates a high hurdle for low-income workers or for workers with limited desire to participate. Contribution compliance may increase if high payroll contribution rates are reduced. As part of an effort to improve compliance by reducing the
mandatory contribution rate, the government may decide that fewer benefits and less generous benefits should be provided. This effect will be limited, however, if pension contributions are only a small part of social security contributions and taxes.

The question of when social security contribution rates are “too” high is specific to the particular country. Some guidance can be provided by comparing with other countries at a similar level of development. In comparing across countries, however, social security contribution rates may differ because of differences in the range of programs that they finance. Ultimately, the question of whether social security contribution rates are “too” high may depend on the extent that those contribution rates distort the labor supply and savings decisions of workers. The extent that distortions occur depends on issues relating to the effect of a worker’s contributions on his or her future benefits (Burkhauser & Turner, 1985), an issue discussed in the next section.

(ii) Tying benefits to contributions

Social security payroll contribution evasion may be reduced by adjusting the formula used to compute social security retirement benefits. The effective net payroll contribution facing workers can be reduced by linking benefit payments to the individual’s contributions. Linking can be done through a defined contribution system, where the payroll payments become contributions to the worker’s retirement account. Notional defined contribution systems are another way to link benefits to contributions. Linking benefits to contributions can also be done through a traditional defined benefit system by tying the benefits to earnings on which contributions have been paid. It is not sufficient to base benefits on earnings. It is important also to require that contributions have been made on those earnings. Doing so provides an incentive to make required contributions. A shift from an unfunded to a funded system may have no effect on contribution evasion unless there is also an improvement in the link between contributions and benefit payments.

Frequently, social security benefits are based on a worker’s earnings over only a few years, such as the three years preceding retirement. This method of calculating benefits provides no incentive for the accurate payment of contributions on worker earnings in earlier years. Employers and employees may collude in underreporting employee earnings for purposes of social security contributions for younger employees and overreporting for older employees. When adequate records can be maintained, it is desirable that benefits be based on earnings over a 10-year period, and a longer period of 30 or more years would be better.

The incentive to evade social security contributions depends on what other contributions are required and workers’ motivation to avoid those contributions. Because workers may have a greater demand for health care than pensions due to the immediacy of the need for health care, linking the payments for the two may reduce social security contribution evasion.

(iii) Government subsidy

In Mexico, all workers who contribute to the mandatory defined contribution system receive a contribution by the government. The government contribution is designed in part to encourage low-income workers to participate in the system. In Greece, Japan and other countries, part of social security contributions are paid for the worker by the government.

(iv) Integration of programs

For low-income workers, poverty program benefits may be only slightly less than their benefits based on their contributions. For this reason, these workers may avoid paying social security payroll contributions and instead rely on poverty benefits and minimum benefit guarantees. Thus, it may be necessary to reduce poverty benefits for workers or improve minimum social security benefits in order to encourage social security contributions by low-wage workers.

(v) Coverage

Widespread contribution evasion may reflect that for some groups, such as workers in the informal sector, it is unreasonable due to their low and variable earnings to expect high participation rates in social security. It may be better social security policy to make coverage voluntary for such workers.

Given that there will be high evasion in some developing countries that attempt to cover most of the workforce, the question in that circumstance arises as to how to design systems where evasion will do the least harm. Widespread evasion fosters disrespect for law. Coverage should only be extended on a
mandatory basis if it can be enforced. Otherwise, the credibility of the system suffers.

Recognizing administrative difficulties for small employers in complying with social security contribution requirements, some countries, for example Indonesia, set a minimum firm size for mandatory social security participation. Other restrictions could involve excluding workers who work less than a minimum number of hours or receive less than minimum annual earnings. A further option would be to have a category of workers and firms for whom participation was voluntary. A problem with voluntary participation and excluded categories of participation, however, is that such provisions open the system to gaming by workers, with them participating in such a pattern as to maximize the value of their participation relative to their contributions. Gaming could occur by workers for whom participation is voluntary by participating only for the minimum number of years.

The contribution law should clearly delineate who is required to register and make payments. In some cases, nonpayment of contributions may occur because employers and workers do not believe they are covered and thus required by law to contribute.

(b) Changes in attitude

Payment of contributions should be encouraged through public relations and educational campaigns as to the benefits of paying and the penalties for not paying. Chile, for example, has a pilot program teaching secondary school students about the social security system. Sometimes contributions are not made due to ignorance as to how and why to do so. In addition, the public perception needs to be established that noncompliance is unacceptable.

The authorities should publicize their enforcement efforts in order to encourage more voluntary compliance. For example, they could print in the newspapers or list on Web pages on the Internet the names of persons or employers who were contribution evaders and publicize penalties levied. Publicizing the names of evaders would increase the reputational cost of evasion. Publicity about widespread contribution evasion, however, may further encourage such evasion since it could change workers’ perceptions about social norms (Sheffrin & Triest, 1992).

An effective strategy for the social security institution may be to enlist the support of labor organizations. While individual workers may be intimidated or lack knowledge as to how to prevent contribution evasion by their employers, labor unions may be more effective in representing the interests of workers who wish to end contribution evasion by employers.

A survey in the US indicated that procedural fairness and responsive service by the tax collection authority cause workers to have a more positive attitude toward compliance (Smith, 1992). Thus, worker attitudes may be linked to administrative practices, which are discussed next.

(c) Administrative changes

The administrative aspects of the contribution process can be analyzed chronologically as the enactment of contribution law, the identification of contributors, the assessment of the contribution, the control and verification of the assessments, litigation if necessary, and collection of contributions (World Bank, 1991). Contribution evasion can result from administrative weaknesses at any of these stages.

Administrative changes in the enforcement of contributions can be divided into three categories: improvement in efficiency, increased inducements (or reduced costs) to contribute, and changes in enforcement and penalties.

(i) Administrative efficiency

Reporting: A change in reporting procedures may improve compliance. An important reason why workers and employers evade social security contributions in both defined benefit and defined contribution schemes is that there is no effective administrative mechanism to identify nonpayment and to enforce payments. In the Ukraine, a new reporting procedure has been proposed. In the past, Ukrainian employers have reported their total contributions to the social security institution but have not indicated for whom the contributions were made. Under the proposed new system, enterprises will also be required to report the names of the workers for whom they are contributing. This system will help identify employers that do not contribute for each employee. It will also help tie pension contributions more closely to benefits.

Employers could be required to report annually to workers the amount of social security contributions they have withheld from the
wages of workers and transferred to the social security institution. This type of reporting helps workers keep track of their social security contributions.

**Methods of contribution collection.** In some countries, such as Kazakhstan, the administration of the collection of contributions is done locally. Contribution enforcement at the local level may be inefficient. Economies of scale may be achieved by organizing contribution collection on a national basis. Strengthening administration may be an important aspect of reducing contribution evasion in both defined benefit and defined contribution systems.

Combining collection of social security contributions and tax collection may in some countries result in better contribution compliance due to more efficient use of resources. Combining the collection of social security contributions with other contributions allows for improved efficiency through specialization in administrative function, with a single collection and enforcement agency. It also facilitates compliance, because employers and workers need make payments only to a single agency rather than to multiple agencies.

In some countries, however, the social security institutions are more efficient in collecting contributions than are the tax collecting authorities, and the two would worsen the collection of contributions. It may be best to keep the collection of social security contributions and income taxes separate because government cannot be trusted to remit to the social security institution all funds collected. The joint collection of taxes and contributions may have serious adverse implications for the administration of social security institutions as autonomous agencies. While this situation indicates serious problems in government administration, it is best to recognize the constraints facing government administration.

In the Chilean individual account pension system, the pension fund management companies are responsible for collecting contributions. They have little incentive, however, to pursue employers that are not providing the required contributions. The costs of such action exceed the benefits to the company. Pension funds may sue employers for unpaid contributions, but competition for clients makes it unlikely that the Chilean pension fund management companies will take actions against clients that are not in full compliance.

In Argentina, which also has an individual accounts system, the collection is done centrally by the government. Unlike Chile, the pension fund managers have no enforcement responsibility, which rests entirely with the government supervisory agency. While it would seem that the Argentinian approach would be more efficient, that can only definitively be determined by the hypothetical comparison of the decentralized versus the centralized collection approach within the same country. A comparison of the two countries suggests that compliance is higher and costs are lower in Chile, but that may reflect a tradition of lower contribution and tax evasion in Chile (Rofman & Demarco, 1999).

**Record keeping.** The administrative authorities need to keep records on taxpayers. Contributions are generally payable monthly. It is necessary to have a mechanism for following-up on those employers who do not pay. An additional administrative check is with the authority that collects the income tax, if that authority is different. Collection authorities could investigate employers or workers who pay the corporate or personal income tax but paid no social security contribution.

Better record keeping by government, including computerization of contribution records, may reduce evasion. The assignment of a taxpayer or social insurance identification number facilitates record keeping and cross-checking of taxpayer information from different sources. It facilitates the use of computers.

In most countries, businesses must register with local authority. This provides information for enforcement. The issuance by government agencies of public works contracts, licences, and permits could depend on social security compliance. In Italy, for example, the increased use of electricity by a firm is used to trigger an investigation of whether a growing company is complying with social security contribution requirements.

**Timeliness:** Improving the timeliness of enforcement actions tends to improve their effectiveness. The United States has found that the faster the Internal Revenue Service (IRS) acts to obtain delinquent taxes, the more likely the action will succeed (US General Accounting Office, 1996).

(ii) **Positive inducements**

Instead of focusing solely on punishing noncompliance, positive encouragement of compliance also may be effective.
Governmental example: In some countries, such as Tajikistan during the mid-1990s, the government, due to a lack of funds, does not regularly pay social security contributions for its employees. Social security finances and the credibility of compliance efforts would improve if the government paid required social security contributions for its employees. Similarly, if it is thought that political leaders personally evade contributions, that provides a negative example for others.

Amnesty: Contribution amnesties, during which penalties and contribution arrears are forgiven, are sometimes granted to encourage future voluntary compliance by noncompliers. A one-time only contribution amnesty may be useful when it signals the change between a regime where noncompliance was tolerated to a new regime where noncompliance would be punished. A one-time amnesty was granted in Bolivia when it switched during the mid-1990s from a defined benefit system to a defined contribution system. The amnesty was designed to encourage participation in the new system. A pattern of periodic contribution amnesties, however, may encourage evasion because the expectation of future periods of amnesty reduces the expected cost of noncompliance.

Simplify laws: Laws concerning social security contributions should be written to the extent possible so that they are simple to understand. Definitions of key concepts such as wages, employees, and tax years should be standardized across different governmental functions. Forms and publications should be designed to be as clear and simple as possible. Likewise, governmental communication with employees and employers should be simple and clear.

Part of simplification could be the simplification of the tax system of which the social security contributions are a part. Employment tax compliance can be burdensome to employers because of multiple taxes charged by different jurisdictions or authorities, each with its own set of rules and regulations, and each with its own set of exceptions.

Knowledge of governmental officials concerning requirements: Government officials should be knowledgeable about the legal requirements so that they provide accurate, reliable advice to employers and employees.

Reduce the cost of complying: The cost of complying can be reduced by reducing the number of forms that employers need to fill out with respect to filing. In areas where filing occurs in person, it can be reduced by making social security offices more conveniently located. In some countries, it may be necessary to open social security offices in rural areas. Otherwise, it may be difficult for people in rural areas to contribute.

In Côte d’Ivoire, to decrease the cost of complying for small employers, they need only pay contributions quarterly. Larger employers are required to contribute monthly.

(iii) Changes in enforcement and penalties

In managing contribution evasion, as is generally the case with violations of any laws, governments must consider how much should be spent on enforcement, how it should be spent, and what penalties should be imposed.

Enforcement: Because of limited resources, enforcement efforts may need to target larger employers. Even for small employers, however, it would be desirable that they should face some risk that the government will detect their contribution evasion through its enforcement efforts. In the Cameroons, the social security institution has encouraged employees to pressure employers to comply.

Enforcement should involve a program of audits, where inspectors visit work sites to determine compliance. The inspections should be done irregularly, rather than on a regular basis, so that employers cannot anticipate the day of the inspection and make adjustments that only apply that day. Enforcement should involve cross-checking income records from different government sources. Another enforcement tool is for the enforcement agency to have the power to take court action against the officers of enterprises.

Corruption: Because tax inspectors generally work alone in the field, it may be difficult to supervise them. A supervisory agency or authority is needed that is responsible for the honesty of the tax inspectorate. Although compliance rather than punishment is generally the goal, ultimately, enforcement may require legal action through the court system, both against corrupt employers and against corrupt enforcement officials. An improvement in the salaries of tax inspectors may need to be part of a campaign to eradicate corruption among the tax inspectorate. It also may be desirable to rotate periodically the geographic area of responsibility of tax inspectors as a way of cross-checking on the accuracy of the enforcement effort.
Penalties: Failure to make mandatory social security contributions should be illegal and should be punishable through penalties. Adequate penalties that are actually levied need to be part of an enforcement effort. Penalties, however, should not be so high as to discourage voluntary reporting of noncompliance. Very high penalties would force employers and workers who initially were noncomplying to continue noncompliance in order to avoid the penalties.

Penalties need to be indexed to inflation or to a market interest rate. Because market interest rates can be readily observed, indexing to an interest rate may be administratively simpler than indexing to inflation. Fixed monetary penalties become meaningless in periods of high inflation.

To strengthen the ability to collect payments, the collection authority can be given power to require employers to provide wage payment records, to recover from bank accounts, to secure payment from third parties who have debts to an enterprise with arrears, and to establish liens on property.

(d) The macroeconomic environment

High inflation, high unemployment rates, and financial distress of employers and public sector employers can motivate contribution evasion. In such situations, financial insololvency of workers and employers may be the cause of contribution evasion. A temporary reduction of mandatory contribution rates and benefits may be required as an emergency measure to keep the social security system operating at a low level. The ultimate solution, however, is to fix the macroeconomic problems.

4. CONCLUSIONS

For contribution evasion to occur, and more generally for violations of legislation protecting workers in the workplace to occur, three conditions are required: (a) employees must either prefer nonpayment of contributions or be reluctant to report nonpayment to authorities, (b) employers must wish to evade or place a low priority on making social security contributions relative to other expenses, and (c) government enforcement must tolerate evasion or be inadequate to prevent evasion.

Evasion of social security contributions is a common problem in both defined benefit and defined contribution social systems. Depending on the causes, administrative and design changes in social security can improve compliance. These fall into four categories: (i) changes in the structure of social security, (ii) attitudinal changes by employers, employees and government, (iii) administrative changes, and (iv) solving macroeconomic problems.

Restructuring social security involves changes that increase the incentives for workers and employers to contribute. Attitudinal changes involve the social security administration adopting a clear policy that evasion will not be tolerated. This also involves changing the attitudes of workers and employers so that evasion is not viewed as an acceptable practice. Administrative changes involve changes in the monitoring of contribution payments and the effective enforcement of the law. For some categories of workers, however, such as the self-employed or workers in small employers, it may be too costly to achieve high rates of compliance, and for these groups it may be best to make coverage voluntary. Macroeconomic changes involve controlling inflation and establishing a stable macroeconomy.

It is important that the problem of contribution evasion be addressed. It should be addressed to assure adequate financing for social security so that retirees receive adequate benefits. Equally important, reducing evasion helps build a society based on respect for law.

REFERENCES


