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RECENT DEVELOPMENTS IN THE COLLECTION OF SOCIAL CONTRIBUTIONS (EMPLOYMENT TAXES)

by

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Robust collection of social contributions (employment taxes) is critical to the viability of contributory pension systems. Collection produces coverage; collection provides revenues to pay promised benefits; collection is also the cornerstone of core administrative functions such as maintaining reliable beneficiary records. Recent developments have the potential to destabilize collection systems and threaten the vitality of social security pension systems. This paper analyzes these recent developments with a view to making recommendations for steps to improve contribution collection systems.

Recent Developments Are Having Major Impacts On Collection Systems - Revenues Are Generally Declining

Adverse Economic Changes. The most notable recent developments are the worldwide recession and rising unemployment. The instability in economies produces stresses that impinge immediately on collection of contributions. Unemployed and underemployed workers do not contribute at expected levels. The market failure in the financial system makes investments problematic and, as a consequence, funded schemes more vulnerable.

Social Changes. Population aging is expected to continue to increase. As a result of recent changes in family structure and labor markets, expected levels of revenue over the long term may be less than as projected even a few years ago as societies have more aged and fewer workers.

New Technologies. New communication and information technologies (CIT) are producing an environment in which public expectations for service are changing. Use of the Internet and higher standards for the rapidity and reliability of communication will increase as the new technologies continue to improve and are used more widely. This will require institutional shifts in the way contributions are collected and accounted for and benefit payments made. Unfortunately, social security institutions are seldom leaders in utilizing new technology and often have difficulty catching up with change.

Public Attitudes. The recession has tended to heighten public skepticism of the capacities of government and public institutions. Greater resistance to payment of contributions (taxes) can be expected. There is also greater public mistrust of financial institutions in the private sector because of the large losses recently sustained and the unreliability of private investment vehicles. Social security pension systems are generally supported by the public, but often must meet expectations that are beyond their capabilities.

Constraints on Administrative Funding. Government deficits have mounted because of the reduction of revenues during the recession as well as the demands for greater government expenditure for recovery. In the United States, for example, there is an unprecedented deficit for the current year of $1.4 trillion. Moreover, large deficits are expected to continue and the continued deficits over the next decade are projected to add $9 trillion to the existing national debt of $12 trillion. This will in turn mean that the government budgets for administrative functions such as social security and tax agencies are likely to be constrained. Thus, the difficulties of operating in a new environment will be accentuated by the restriction of resources.

Enhanced Uncertainty. An issue will be what is the "new normal" for national economies and what this means for society and programs such as pension systems. Historically, big systems like public pensions and tax collection do best when they are stabile and change incrementally. But incremental changes may not be enough to meet the challenges being presented by having so many system threatening developments take place at the same time. The enhanced uncertainty may require new mechanisms for change. For example, in the United States there are proposals for special commissions to address deficit reduction that have strong mandates and quasi-legislative powers to bring about change in entitlement programs, including social security pensions. In the final analysis, however, procedural mechanisms to bring about major changes must be backed by political will power by governments with strong public support if they are to be successful.

Collection Systems Require Continuous Adaptation to Change[1]

As recent developments confirm, the problems confronting collection systems are complex and constantly changing. The current dynamics of society and the economy must be continually addressed. For example, as economies restructure themselves, new challenges are presented by increasing numbers of self-employed workers and atypical workers. Often these workers work at home or have no established place of business. Traditional employer-employee withholding systems do not reach this newly expanding work force. Collection requires special effort by the authorities.

As large-scale immigration continued, new contributors present growing challenges to record-keeping and benefit payment mechanisms. Changes in the population require constant attention in order to cope with differences in language and culture.

Communications and information technology are changing rapidly. As a result, contracting out of CIT increasingly takes place. But core competency must be maintained in a collection agency if it is to effectively utilize outside contractors. Maintaining balance between employees familiar with the business model of an agency and outside experts familiar with new technology is necessary for efficient and effective operations.

The basic issue is to determine what form of organization will best adapt to these constant changes. No doubt specialized CIT services are needed, and many functions can be transferred to outside contractors. But if too many of the core functions of a public institution's collection system are contracted out, it may not be long before the public character of a social security pension system is undermined and eventually lost.

The effects of the recession are dramatically apparent in Central/Eastern Europe. Many of the countries that added second-pillar funded pensions have taken steps to transfer the contributions to the second-pillar funds to the first-pillar pay-as-you-go system in order to be able to continue to pay basic pensions. While in most places, there is a commitment to restore these contributions to the second-pillar funds at some point, it is uncertain whether this can actually be done in a fiscally sound way. It is likely that in some cases a notional defined benefit will be established to attempt to make beneficiaries whole. It may also be found to be more efficacious to eliminate second pillars and to restructure first-pillar systems to be more cost effective. There is also renewed interest in social pensions (means-tested benefits) to meet basic societal needs.

Even before the recent collapse of some second-pillar systems, it was evident that the concept of mandatory, funded defined contribution pillars raised serious issues. Administrative expenses were generally too high and expected returns from investments were often far below expectations, rendering projections unreliable. Proposals were made to hold down administrative costs by government regulation and to have the state guarantee investment returns. At some point, the systemic problems of second pillars suggest that properly designed pay-as-you-go systems are a better alternative to meet basic pension needs.

In sum, many Central/Eastern European countries may need to redesign their systems once again, taking into account EU fiscal requirements. While the prospects are good that countries in the EU can produce pension systems that are sustainable, many difficult choices must be made and a long-term approach must be followed.[2]

South American pension experience continues to be problematic. Thus, in Chile, long an exemplar for mandatory defined contribution plans, most beneficiaries are now reconciled to relying on the guaranteed minimum pension and have ceased contributing to defined contribution plans at expected levels. The unfortunate experience of Argentina, while unique in many respects, could be seen as a cautionary lesson in many places. Private pension funds, first created to avoid the mismanagement of public pension funds, were later taken over by the government. Pensioners have not had adequate and secure pensions at any stage.

Some countries have been fortunate in not pursuing the mandatory defined contribution model. Thus, Brazil has remained with a basic pay-as-you-go system and is successfully using social pensions to address poverty issues. The United States has rejected the privatization proposals of President George W. Bush and continued with a partially funded PAYGO system, supplemented by entirely voluntary private pensions/individual account systems.

Each country builds on its own foundations, but ultimately a pension system must generate sufficient public confidence that contributions can be reliably collected so that benefits can be reliably paid.

Recommendations: Aggressive Enforcement Steps Need to be Taken Promptly to Combat Avoidance and Evasion and Encourage Voluntary Compliance[3]

Contribution collections are generally lagging below forecasts for all kinds of social security pension systems. Some of this shortfall may be reversed when economic recovery takes hold, but it is important even in the short term to try to maintain as strong collection of social contributions as possible. In general, this will require that more aggressive enforcement steps be taken promptly. Particularly with more self-employed and atypical worker patterns, collection activities often need to be refocused. Some of the steps that should be taken are:

Adopt a Comprehensive Compliance Strategy. Business as usual will not be adequate. The changes taking place must be recognized and techniques developed to improve the collection activity. In this regard, there should be an attempt to utilize new technology both to increase compliance and to take enforcement actions. The fact of the economic downturn should be used as an argument to get increased resources to do a better job. Short-term (1 to 2 years), medium-term (5 to 10 years), and long-term (10 to 20 years) plans need to be developed and meshed. The consequences of the very significant changes taking place need to be addressed promptly and over the longer term.

Address New Obligations Forthrightly. Social security agencies need to embrace the new obligations that are being placed on social security recordkeeping systems. Increased data exchanges are needed that can benefit both other agencies and the social security agencies. In the United States, for example, homeland security, immigration, and law enforcement demands on social security data and information are increasing and must be met as fully as possible. It is no longer possible for social security and tax collection systems to function solely for their own purposes.

Pursue Delinquent Contributors Promptly and Forcefully. Agencies must be more active in identifying persons who owe taxes, acquainting them with their obligations; making prompt assessments where compliance lags; and taking prompt action to collect those assessments.

To get the resources for this increased activity, social security collection agencies need to buttress their claims with cost-benefit analyses. In the United States, for example, often money spent to provide more aggressive enforcement returns five or even ten times that amount in collections. Whether this magnitude of return would be achieved under current conditions is less certain, but it is reasonable to proceed aggressively and not to passively accept declining collections.

A Government-wide Approach to Collection Is Needed In All Events

A government-wide approach to collection is needed and traditional tensions between social security agencies and tax agencies need to be surmounted. In 2004, two papers I authored suggested there was a trend toward integrating income tax and social contribution collection systems.[4] The advantages of building a single, up-to-date system have been increasingly accepted, and more countries have pursued integration. For example, in Central/Eastern Europe, Macedonia has recently successfully integrated collection of social security contributions and taxes and established reciprocal data flows between the tax authority and the pension agency. Steps toward integration have been taken recently in Hungary, Romania, Albania, Estonia, Latvia, Lithuania, Serbia, Bosnia/Herzegovina, and Montenegro.

The only country that has seemingly reversed a decision to integrate collections is Russia. However, following that original decision, the tax authorities apparently did not take steps to collect adequately the pension tax or to provide necessary data to the Pension Fund. Thus, this experience may be seen as essentially a failure to implement appropriately an apparent decision to integrate rather than a failure of an integrated system to work effectively.

There are examples of integration elsewhere. Brazil has pursued integration in Latin America. Vietnam and Korea in Asia have taken decisions to integrate in the next few years.

But many countries continue with parallel collection systems. Moreover, revenue collection systems are complex and there are important differences in structure and organization from country to country, even in unified systems.[5]

What are the reasons that duplicative collection systems persist? In some cases, the social contribution collection system is seen as relatively efficient and supporting a reasonably vibrant pension system. This is the case in France and Germany, for example. But in many cases the persistence seems largely based on inertia or denial of realities.

Social security executives often prefer parallel collection systems. They then are in control of social contribution collection activities, thereby securing and managing their own funds, and using the funds at the appropriate time to pay benefits. However, social security executives need to understand that tax collection agencies generally have inherent advantages. In countries where the revenue administration is efficient, the tax system linkages to contributing individuals and businesses may be far stronger than those of the social security agency. Since the major mechanisms for collection of social security contributions are withholding from individuals and businesses, the tax collection agencies generally would have the systems and resources to do a better job. An integrated system can provide better experience for taxpayers as well as the government, simplifying procedures and providing other efficiencies..

Tax collection agencies also tend to be better at specialized collection activities such as auditing, assessment, and enforced collection. Staff recruitment and training generally may be more readily accomplished than at a social security agency. While the tax agency could provide these services to the pension agency, it may be better to have these responsibilities which are normal for them, but often extraordinary for social security agencies, directly taken on.

The tax collection agencies generally should be able to secure greater resources for collection activities since they should be able in a relatively short time to show the benefits of increased enforcement activity across the entire revenue system. Thus, collection of individual income taxes, business taxes, and value-added taxes may be increased at the same time as social contributions (employment taxes), using the same resources and modern collection techniques.

At the same time, revenue collection executives need to be sensitive to the data requirements of pension agencies. The cooperation that is needed will not take place if data flows from the tax collector to the pension agency are not timely and adequate for the pension agency's uses. In various places where the revenue collection function has been shifted from a pension agency to a tax agency, it often has taken too long and been unnecessarily difficult to secure the reciprocal data flows.

Both pension and tax professionals must recognize that social security policy is often in the hands of economists who are more interested in macroeconomic aspects of the system (particularly the effects of benefit structures) than the mundane task of collecting revenues.[6] Indeed, economists often assume collections will take place as forecast, whether that expectation is realistic or not. For example, World Bank officials have spent large amounts of resources on helping countries design and redesign their benefit systems while spending relatively little time on helping them build administrative structures, particularly collection systems.[7] The World Bank usually regards collection systems as a country specific issue and does not advocate a position, often accepting inefficient parallel systems, but supporting integration if a country decides to follow that path. The IMF generally encourages efficiency and cost-effectiveness through integration. Its Fiscal Affairs Division has over the years developed considerable expertise in monitoring expenditures and revenues and providing instrumental technical assistance on tax policy and revenue administration. Whatever the outside advice, unless pension officials and tax professionals in a country reconcile their viewpoints and work together effectively it is unlikely that the government will be able to maintain adequate revenue collection in a difficult environment.

Finally, political systems often neglect the collection subject, except in extreme circumstances when strong steps must be taken to avoid dire consequences. Yet the public benefits if in normal circumstances everyone in the government cooperates and a government-wide approach is taken. The importance of data exchanges is growing as government becomes more dependent on the new technologies. If collections can be improved, then data can be improved and exchanges can be improved that benefit agencies in all areas. Ultimately, the public will be the beneficiary if the political system leads to government agencies improving collection administration.

The U.S. Experience: A Model for Integration and a Need to Address the Tax Gap

Viewing the U.S. experience on contribution (employment tax) collection can be instructive. The United States has the single largest social security system in the world and it basically operates efficiently and at low cost (less than 1% of expenditures). The U.S. collection system is very efficient by any standard, public or private. The U.S. Social Security system was developed after the tax collection system was in place, so from the beginning in the 1930's federal employment taxes (social contributions) were collected by the Internal Revenue Service. Thus, the Social Security Administration could be a public pension administrator unburdened by the collection function and the United States is a proven model for integrated collection.

There is no question that the IRS is an efficient tax collection agency. It collects vast amounts with relatively modest costs (about 0.5% of revenues), mostly with voluntary compliance by taxpayers. The U.S. public is generally compliant with its obligations. About 84% of all revenues are paid timely and voluntarily; and about another 6% is paid late, after some routine enforcement action, such as sending notices and other automatic follow-up steps, or then more strenuous IRS enforcement actions such as audits and enforced collections.

Tax Gap. Even in the United States, however, there is a large tax gap, i.e., the difference between what is legally due and what is collected. The gap is roughly about 10% of the legally due amounts.[8]

The most recent in-depth study of the tax gap was done in 2001 and showed a gap of roughly $300 billion, about 20% of which, $58 billion, was in employment taxes. Most of that related to self-employed and atypical workers. The collection from employees through withholding by employers did not significantly contribute to the gap. It may be extrapolated that currently the tax gap in the United States is about $400 billion and the amount due to wage taxes is probably around $80 billion, although it may be as large as $100 billion because of the difficulties created by the economic recession.[9]

A gap this large in collection could be a factor in Social Security pension reform. Total Social Security collections are roughly about $800 billion annually, so the current gap of $80 - $100 billion could be 10% or more of the revenues owed the system. The issue of addressing the tax gap could arise as part of entitlement reform designed to reduce the deficit or in a programmatic reform of the Social Security system.

President Obama has created a tax reform task force under former Chairman of the Federal Reserve System Paul Volcker. This task force has been charged with addressing the problem of the tax gap as it develops recommendations for changes in the tax system. Hopefully, the efforts of the task force will result in enhanced collection activity.[10]

Trust Fund Accounting. The U.S. has an unusual way of accounting for the amounts of federal employment taxes that are in the Social Security Trust Funds to pay benefits. The accounting is done by an estimation process based on the amount of earnings reported rather than by the amount of actual collections. Thus, non-payment of employment taxes affects the Treasury general fund but not the Social Security Trust Funds. Only non-reporting deprives the Trust Funds of its revenues. The Social Security actuaries and Treasury revenue estimators are adept at looking at data to make the transfers from the Treasury general fund to the Trust Funds. However, there can be no doubt that most of the employment tax gap is in non-reporting and under-reporting, which means that it would affect the amount of revenues going into the Social Security system to pay benefits.

The self-employed must file and pay employment taxes themselves. They do it on an estimated basis during the year with a reconciliation at the end of the year. It is often estimated that about one-half of self-employment income goes unreported. Moreover, many employees are treated as independent contractors, which puts people in a category where they may avoid or evade wage taxes more readily. There has been increasing informalization of the economy in the last few years. Official unemployment is near 10% and perhaps another 10% in under-employment, which means that as much as 20% or more of the workforce may have incentives not to report income and pay employment taxes.

Remedying the Tax Gap on Wages. The IRS has generally given higher priority to enforcement in other parts of the tax gap. Even though the special study in 2001 revealed the considerable size of the collection gap attributable to wages, there has been no concerted effort to identify the noncompliant self-employed or to treat independent contractors as employees.[11] The IRS continues to use its limited enforcement funds for other areas it considers more important such as pursuing business tax compliance, particularly international business. The IRS mainly tries to encourage voluntary compliance with the wage taxes. Moreover, congressional appropriations for tax collection are restricted and even the areas for which the IRS gives high priority are typically underfunded.

It is generally believed to be undesirable to raise taxes during an economic downturn since doing so may impede recovery. Also, it is possible that if there is an economic recovery, collection levels will return to a more normal level. This is uncertain, however, since businesses and workers who become noncompliant may choose to continue to avoid or evade taxes rather than to return to a more customary stance of meeting their tax obligations. Thus, it could be beneficial for the United States to spend more resources to become more aggressive, even in a time of recession, by developing Internal Revenue Service capacity to identify nonpayers, make assessments, and pursue enforced collection.

It generally takes about two years of training after a tax auditor is hired for that person to be effective. Thus, it would be several years before anyone hired now as part of economic recovery could be productive in securing more collection of employment taxes. By then the deepest part of the recession hopefully will have passed and the auditor could be helpful to restoring integrity to the tax collection system. Accordingly, some are recommending that the

Internal Revenue Service hire people now and start training them in order to improve future enforcement.

As even this brief description of the U.S. experience shows, it is evident that the Internal Revenue Service is in a better position to uphold collections than the social security agency would be if it were discharging the collection function. The Social Security agency is underfunded even for its present activities of paying benefits, maintaining benefit records, and exchanging data with other agencies. The social security agency receives and processes wage reports. SSA provides the resulting data to the IRS, but except for this limited function, it performs no collection activities except with respect to recovery of benefit overpayments, where its record is not good.

As the U.S. experience demonstrates, for those countries operating parallel collection systems, now is a good time to take a careful look at whether the pension agency or the tax collection agency should be the collector of social contributions. Social contribution collection may be enhanced even in a difficult economic and social environment by aggressive administration.

Maintaining Accurate Beneficiary Records. The Social Security Administration (SSA) assigns identification numbers to individuals which are also used for tax and other governmental purposes.[12] This is a core workload and provides the basis for maintaining current earnings records and, at the appropriate time (e.g., retirement or disability), making payments to beneficiaries.

Wage reports must have correct names and identification numbers to be posted to the Master Earnings File and about 92% are filed accurately. However, approximately 8% of the wage reports are unable to be posted as filed. Over a relatively short time, about 4% of these are reconciled and entered into the system, but the final 4% are put into an Earnings Suspense File (ESF). For the period 1937 through 2007, this suspense account has grown to almost 300 million wage items, amounting to over $800 billion in uncredited wages. In some cases, these wage records will never produce benefits for anyone, but in some cases SSA will be able to credit them to beneficiaries at some point. SSA mails annual Social Security Statements to all workers age 25 years and older who are not receiving benefits, so they can check for missing or incorrect items and seek correction. SSA also encourages employers to verify names and identifying numbers contemporaneously through the agency to avoid problems. Generally, an effort is made by SSA at the time when a claimant is enrolled for benefits to be sure the wage record is complete so the correct benefit can be determined.

Given the size and age of the U.S. Social Security system, the size of the ESF is not surprising. However, efforts are made continually to be more accurate on a current basis. Whether these efforts are adequate is a source of continuing concern.

Conclusion: Collection Is A Fundamental Priority

Recent developments are having major impacts on collections. Many contributory social security systems are in peril and need to take aggressive enforcement steps to maintain their viability. Government-wide approaches to collection need to be followed and integrated collection systems should be initiated in many circumstances to achieve maximum cost-effectiveness. There has been too much complacency for too long by social security executives about inadequate collection systems. Social security organizations and revenue collection agencies need to work cooperatively to reconcile their views and make greater efforts to achieve efficiency and effectiveness for the programs intended to benefit the society as a whole. Political will power is a fundamental requirement for success. In short, collection must be made a top priority by governments if contributory pension systems are to be maintained in increasingly difficult circumstances.

Endnotes

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[1] For a functional description of collection systems, see Stanford G. Ross "Common issues of social security and taxation systems" in Interactions of Social Security and Tax Systems (ISSA/OECD 1997).

[2] See Sustainability Report - 2009, European Economy 9/2009, European Commission, Directorate-General for Economic and Financial Affairs (October 2009).

[3] For background, see John Brondolo, Collecting Taxes During an Economic Crisis: Challenges and Policy Options, IMF Staff Position Note, SPN/09/17 (International Monetary Fund) July 14, 2009.

[4] Stanford G. Ross, Collection of Social Contributions: Current Practice and Critical Issues, A paper presented at the International Conference on changes in the structure and organization of social security administration (ISSA June 2004); Peter Barrand, Stanford Ross, and Graham Harrison, Integrating a Unified Revenue Administration for Tax and Social Contribution Collections: Experiences of Central and Eastern European Countries, IMF Working Paper WP/04/237 (International Monetary Fund December 2004).

[5] For a detailed analysis of tax collection administrations, see Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2008), prepared by the Forum on Tax Administration, Centre for Tax Policy and Administration (OECD January 28, 2009), especially at pages 16-18 and 29, regarding social contribution collections and integrated systems.

[6] See Stanford G. Ross, "Doctrine and practice in social security pension reforms," International Social Security Review, Vol. 53, No. 2 (2000).

[7] See Pension Reform and the Development of Pension Systems: An Evaluation of World Bank Assistance (Independent Evaluation Group, The World Bank 2006); Mitchell A. Orenstein, Privatizing Pensions: The Transnational Campaign for Social Security Reform (Princeton Univ. Press 2008).

[8] See Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Impact, Congressional Budget Office, U.S. Government Accountability Office, and Joint Committee on Taxation, GAO-08-703SP (June 2008).

[9] See Eric Toder, "Focus on the Tax 'Avoidance' Gap," Tax Notes (September 7, 2009); Tax Compliance: Businesses Owe Billions in Federal Payroll Taxes, GAO-08-1034T (July 29, 2008). These estimates are frequently regarded as low by knowledgeable observers.

[10] See Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap, GAO-07-488T (February 16, 2007).

[11] See Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance, U.S. Treasury Department (July 8, 2009).

[12] See Anya Olsen and Russell Hudson, Social Security Administration's Master Earnings File: Background Information," Social Security Bulletin, Vol. 69, No. 3 (2009).