Paying for public spending: taxation

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"Our tax collectors are like honey bees, collecting nectar from the flowers without disturbing them, but spreading their pollen so that all flowers can thrive and bear fruit."

Pranab Mukherjee, India's finance minister, budget speech, July 2009

Executive summary

Like spending, levels of taxation rise alongside economic growth: low tax economies lag behind in development. Tax collection services need to be properly resourced to prevent tax evasion.

The burden of taxation has become less fair, because countries have moved towards regressive taxes such as value added tax (VAT), which hit lower incomes harder, and because companies have managed to pay less and less, despite a rising share of national income. Dealing with tax havens and introducing financial transaction taxes ('Tobin tax') should be part of this process.

Overwhelmingly, the increase in government deficit and debt has been due to the crisis, not to spending profligacy by governments. Attacks on these deficits risks pushing economies back into recession. Fiscal limits, such as the EU rules against deficits over 3% of GDP, are arbitrary figures. Markets speculate against countries' borrowing because they are relatively small; there is no link with actual deficit or debt levels.

The IMF and the EU attacks on public spending on pensions and healthcare would cut spending on the most efficient ways of providing these benefits. The IMF wants to see cuts of over 8% of GDP, equivalent to cutting by half all the government contracts in the world. Cuts in these services have been strongly resisted in many countries. The better alternative is to develop stronger and fairer taxation systems and to continue to grow public spending to meet the challenges of the future, including climate change.

Introduction

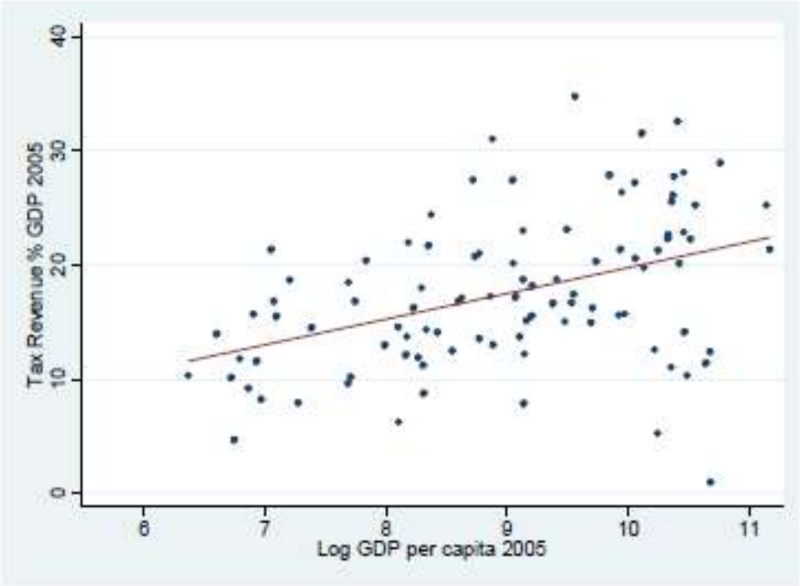
Public spending has to be paid for. The key source of revenue is taxation (and social insurance contributions), with some revenues also from aid for developing countries. This section looks at the issues of how much taxation is affordable, and how the tax burden can be fairly shared. It also looks at government deficits and debt, which are used to cover any gap between taxes and spending, and the economic role of this borrowing – especially in an economic crisis.

1. Affordability: the level of taxation

There is a clear and positive correlation between a high level of taxation and higher gross domestic product (GDP), as shown in the chart below. Even the World Bank consistently draws attention to the possibility for higher levels of taxation and the positive links with economic output. In discussing the need to achieve the millennium development goals, the World Bank and the International Monetary Fund (IMF) have stated: "in most developing countries the problem is collecting enough revenue to provide essential public infrastructure and human development services." (World Bank 2004)

Although tax revenues in middle-income countries have started to rise significantly, the poorest countries have mostly made very little progress in increasing the level of taxation. Indirect taxes – taxes on spending, such as VAT or sales tax - increased most, but these are the least progressive taxes, which hit the poorest hardest. Direct taxes – taxes on the income and capital gains of people and companies - grew very slowly, partly because the rate of tax on company profits has been cut, in accordance with the advice of the IMF. Taxes on trade have stagnated or even fallen, mainly because of trade liberalisation through the World Trade Organization (WTO), which requires countries to cut the taxes they levy on imports or exports.

Chart A. Tax revenues as % of GDP rise as GDP rises



Source: DIE 2009

Table 1. Tax revenues as % of GDP in OECD countries, 1975–2008

	Total tax revenue as percentage of GDP							
	1975	1985	1990	1995	2000	2006	2007	2008 Provisional
OECD Total	29.4	32.6	33.7	34.7	36.0	35.8	35.8	
of which:								
EU 15	32.1	37.5	38.1	39.0	40.6	39.8	39.7	
Japan	20.8	27.4	29.1	26.8	27.0	28.0	28.3	
United States	25.6	25.6	27.3	27.9	29.9	28.2	28.3	26.9

Source: OECD tax database www.oecd.org/ctp/taxdatabase

Table 2. Government revenues in low income countries as % of GDP, 1990–2006

	Sub-Saharan Africa			South and south-east Asia			Central Asia		
	1990–1994	1995–1999	2000–2006	1990–1994	1995–1999	2000–2006	1990–1994	1995–1999	2000–2006
Direct taxes	2.9	3.3	3.8		2.2	3.1		7.5	9.2
Indirect taxes	3.5	3.9	5.0		3.8	4.6		8.4	10.0
Trade taxes	3.8	3.9	4.1		3.1	2.2		1.7	1.8
Total taxation	10.9	11.8	12.9	-	9.8	10.6	-	18.5	21.9
Total revenue	13.3	14.1	15.6	-	12.5	13.7	-	21.8	25.2

Source: McKinley and Kirili 2009

2. Fairness: the burden of taxation

2.1 Sources of government revenue: taxation, insurance, charges and others

The most significant form of public finance is taxation, but public services are also financed through:

- charges to users of services such as fares paid by passengers on public transport;
- various forms of insurance, including social insurance or health insurance paid by employees;
- state borrowing, e.g. through loans from development banks or selling bonds;
- income from international aid (or regional solidarity funds within the EU); and
- profits from state-owned companies and charitable donations.

The main types of taxes are set out in the table below. The fairest form of taxation is the most progressive: that is, taxes which result in people (and companies) with higher income and wealth paying a higher proportion of their income than people with lower incomes. The key progressive taxes are income tax, corporation tax, and property tax. Taxes on consumption are usually regressive – i.e. the poor have to pay a higher proportion of their income – but specific taxes on expensive items mainly bought by richer people, such as cars, may also be progressive.

Table 3. Sources of public revenue

	Progressive	Type	Example
Taxation	Yes	Income tax	Income tax
	No	Sales/consumption tax	Value added tax (VAT), petrol tax
	varies	Trade taxes	Import duties
	Yes	Property tax	Rates, estate tax
	Yes	Corporate taxes	Profits tax, capital gains tax, transaction taxes
Insurance	No	Social insurance	Pension contributions, unemployment insurance
	No	Health insurance	Health insurance premiums
Other	No		Licence fees,
Charges	No	Utility charges	Water charges, electricity charges, fares
	No	Service charges	Education fees, housing rents, drugs charges
Borrowing	No	Bonds	Government, municipal bonds
	No	Loans	Borrowing from banks, development banks
Other	Yes	Aid	Aid budgets of rich countries
	No	Profits	Surplus of state or municipal companies, interest on loans
	No	Donations	Charity, voluntary labour

The main trends in taxation in the last 20 years have been away from progressive taxes. There has been a great pressure to increase the role of value added tax (VAT), in particular; while corporation tax has declined. In addition, trade taxes have been reduced in order to comply with the trade liberalisation policies required by the World Trade Organization (WTO). For low- and middle-income countries, this has meant having to increase other taxes simply to stand still, because the revenue from trade tax has declined. [a] Baunsgaard and Keen 2010)

Table 4. Tax revenues (excluding social insurance) by type of tax and country income group

Income group	Total Taxes as % of GDP	… of which (as % of GDP):				
		Profits tax	personal income tax	Consumption taxes	Trade taxes	Other
Lower	14.1	2.7	2.3	6.1	2.3	0.7
Lower middle	16.7	2.6	2.7	8.7	1.6	1.1
Upper middle	20.2	1.8	4.1	10.7	1.1	2.5
Total, lower and middle	17.6	2.3	3.2	9.0	1.5	1.6
High	25.0	2.4	11.2	8.2	0.2	

Source: Gordon and Lei 2009

Box A. Taxation in Ghana

Ghana's level of taxation is unusually high for a low-income country. The country increased its tax revenue from only 4.0% of GDP in 1982 to 21.6% GDP by 2007. The 2010 budget sets a target of collecting 23.4% GDP of tax revenue. The reforms in the 1980s were heavily influenced by the IMF, World Bank and other international donors, with the emphasis on shifting the tax burden away from agricultural producers towards consumers, through VAT. But VAT as an indirect tax is regressive, so the burden falls heavily on ordinary workers who spend all their incomes on consumables.

Ghana has created some specific links between taxes and public services. VAT is levied at a rate of 15%, of which:

- The equivalent of a 2.5% rate of VAT is reserved for education (i.e. one-sixth of the total VAT);
- The equivalent of a 2.5% rate of VAT is reserved for social health insurance (i.e. one-sixth of the total VAT);
- 20% of the communication service tax is ring-fenced for a national youth employment scheme.

In a major policy shift from the earlier tax policies influenced by the World Bank and IMF, the 2010 budget has made an attempt to increase the direct tax revenue and to re-introduce some trade taxes. The budget targets to increase direct taxes by 9.8% by: increasing royalties on extractive industries to 6%; increasing road tolls, car licensing fees, and rent tax; and by the re-imposition of 40% import duties on some luxury goods (which is progressive) but also on rice, poultry and vegetable cooking oil (which is not progressive).

2.1 Property tax and land tax

Property taxes in high-income countries are, on average, about 2.1% of GDP, but only 0.6% of GDP in developing countries. The advantages of a property tax are that it is fair, hard to avoid, and impacts on people with assets whose value is increased by public services and infrastructure. If developing countries raised property taxes to the level of 2.5%, it could help fund local governments in particular – for example, in Thailand, such a tax would finance *all* local government spending.

A land tax is even broader, because it taxes all land, not just the buildings on it. It also taxes the value that landowners gain from economic growth and rises in property prices. Hong Kong uses a land tax to raise 38% of its revenues. Australian local governments use a land tax, and the government is considering extending it to cover all commercial and industrial property. Thailand is introducing a new law to enable municipalities to tax land values, and charge double rates on land which is unused. (Bangkok Post 2010)

There are campaigns for a land tax in many countries, including Latvia, where a group of economists and others argue that introducing a land tax would be an alternative to the savage cuts in public spending that have been introduced in that country. There have been many calls for a land tax, including from Adam Smith, Tom Paine and Winston Churchill, who argued:

> "Roads are made; streets are made; services are improved; electric light turns night into day; water is brought from reservoirs a hundred miles off in the mountains – and all the while the landlord sits still. Every one of those improvements is effected by the labour and cost of other people and the taxpayers. To not one of those improvements does the land monopolist, as a land monopolist, contribute, and yet by every one of them the value of his land is enhanced. He renders no service to the

> community, he contributes nothing to the general welfare, he contributes nothing to the process from which his own enrichment is derived." (McLean 2004)

Table 5. Property taxes as % of GDP

	1990s	2000s
OECD countries	1.4	2.1
Developing countries	0.4	0.6
Transition countries	0.5	0.7

Source: Roy Bahl 2009

2.2 Corporate taxation

Companies in high income countries are actually paying a lower rate of tax than they were 25 years ago. Over this period, corporate profits have increased their share of GDP in the major OECD countries, so that it now represents about 35% of GDP, compared with only about 25% in the early 1980s (see chart C, below).

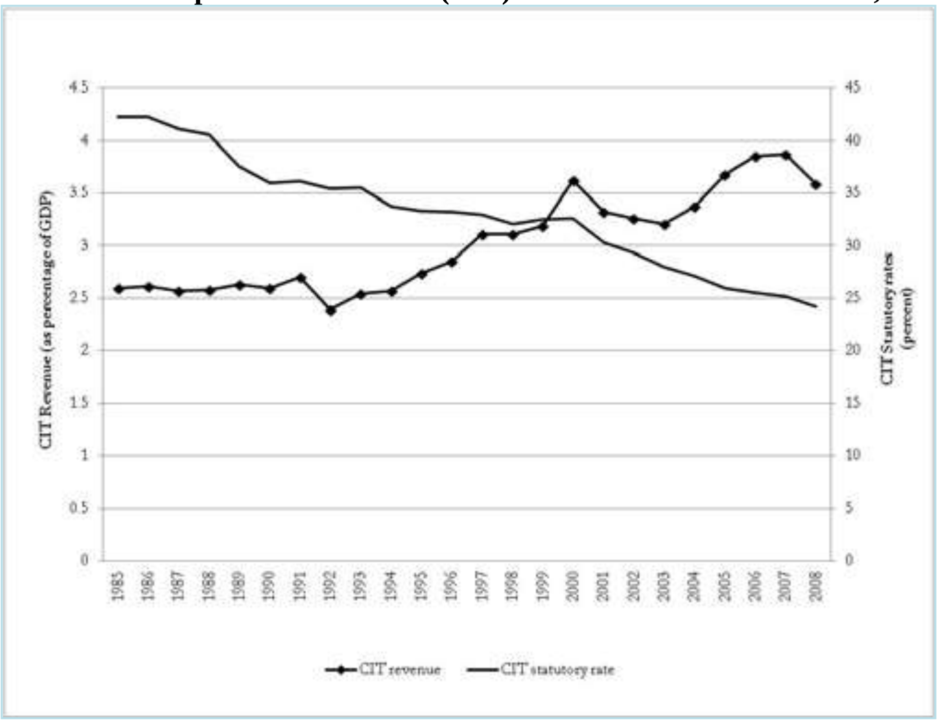
But as a result of political pressures, new forms of tax evasion, and what the IMF calls 'international tax competition' the average rate of corporate income tax (CIT) paid has almost halved, from about 42% in 1985 to about 24% in 2008 (see chart B, below).

The net result is that the total tax paid by corporations has risen, but only to about 3.6% of GDP (see chart B). If corporations were still paying at the same effective rate as in 1985, they would be contributing tax equivalent to over 6% of GDP. The missing tax, worth over 2.5% of GDP, has to be found from other sources.

This combination of trends has meant that the post-tax income of companies has risen far more rapidly than the post-tax income of people. Chart D shows the picture for the USA. At the worst point in the current recession, post-tax corporate income had fallen back to 'parity' with personal post-tax incomes, both being a bit over 2.5 times the level of 1990. But before 2008, corporate post-tax income had reached more than 5 times the1990 level – and, remarkably, had recovered by 2011 to nearly 6 times the 1990 level.

This is not only unfair, it creates greater unemployment. Companies spend less of their profits than people spend of their incomes, so taxing profits has less of an effect on overall demand in the economy, so that there are more jobs in the economy as a whole. (Bettendorf et al 2009)

Chart B. Corporate Income Tax (CIT) Revenue in OECD countries, 1985–2008



Source: IMF 2010

Chart C. Wages/profit shares in GDP, EU/USA/Japan, 1960 to 2008

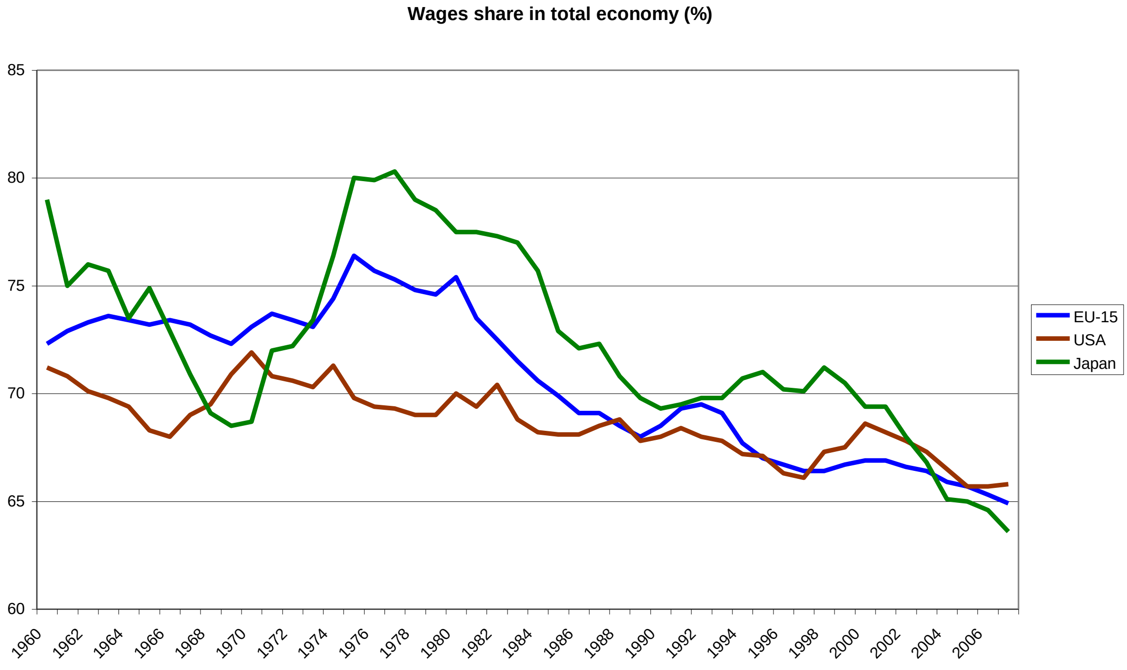
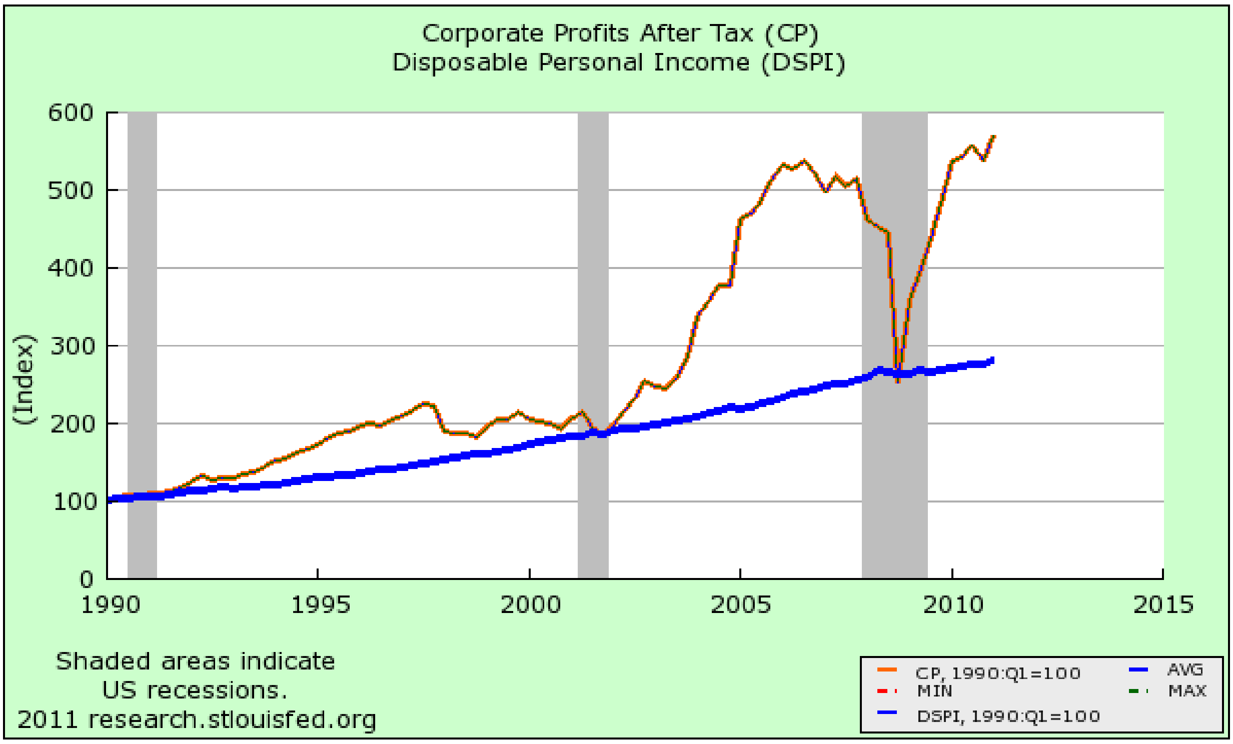


Chart D. Corporate profits after tax, and personal income after tax, USA 1990–2010



Source: US Dept of Commerce, Bureau of Economic Analysis http://research.stlouisfed.org/fred2/graph

There are two major problems with corporation tax. One is that most countries allow companies to offset the cost of paying debt interest. As a result, firms that use high levels of debt (such as private equity companies) do not pay any tax on the part of their profits which is paid out as interest. This not only reduces the amount of tax actually paid, it also encourages firms to increase debts, which was one factor causing the economic crisis. Even the IMF thinks that this exemption is unfair and economically dangerous: “Corporate-level tax biases favouring debt finance, including in the financial sector, are pervasive, often large, and hard to justify, given the potential impact on financial stability … Tax distortions are likely to have encouraged excessive leveraging and other financial market problems evident in the crisis”. (IMF 2009)

The other, and greatest problem, is that multinational companies and finance companies can move freely around the world. They can choose to operate in countries with lower tax rates on profits – or none at all, in the case of tax havens. So countries are under pressure to reduce their levels of company taxation in order to attract investment – even if their need for public services and infrastructure has risen. Countries have tried to attract companies by offering special reductions or allowances. Many developing countries offer free trade zones, where company profits are not taxed. This also happens within countries, where municipalities have tried to offer special concessions to attract company activities. The companies themselves have an incentive to encourage this ‘tax competition’: if countries think that high tax rates on profits will cause a multinational to relocate much-need investment elsewhere, then all countries are likely to lower their tax rates, and the multinationals will benefit, wherever they go.

However, tax rates are only one factor in deciding where a multinational company operates. (In some sectors, like mining or oil, or utilities such as electricity and water, it cannot possibly have an impact: the multinational cannot choose to move the mine or the town to which it supplies electricity!) Many other factors affect company decisions on the location of production, including the availability of public infrastructure like roads, rail, electricity, and education.

So it is important not to exaggerate the effect of taxes on corporate decisions on the location of their operations.

It is equally important to recognise the positive attractiveness of well-financed public infrastructure. Countries or regions which reduce spending on these factors in order to cut profits tax may actually make themselves less attractive locations. A study of USA multinationals' decisions found that, in developing countries: "… infrastructure quality appears to be an especially important determinant. Tax rates, on the other hand, do not seem to be important for investment decisions". The solidarity funds and cohesion funds of the EU create "more favourable conditions for investments in central and eastern Europe through funding training, infrastructure and R&D". A recent study on investment decisions by Japanese firms in developing countries concluded:

> *The improvement of public governance and the ability of a government to provide public goods such as health, education, and infrastructure, appear to be the best long-term strategy to raise national welfare because that reinforces the long-term attractiveness of the host country, benefits to every enterprise without considering their nationality, and increases the possibility of benefit from FDI.* (Slemrod 2004)

Companies can also avoid paying high taxes, by 'income shifting' their profits from one country to another. If a multinational has a subsidiary operating in a country with high corporation tax, it can change the way it records its finances so that more income appears in a subsidiary operating in a country with a much lower tax. One way of doing this is by 'transfer pricing', so that the subsidiary in the low tax country charges the subsidiary in a high tax country a very high price for an internal company transaction, with the effect that profits appear elsewhere. So even without moving the actual operations, the company can avoid tax in one country by paying less in another. The country does not lose the jobs, but it may still lose the tax revenues.

This is much easier for countries with controls on the movement of capital. Countries started trying to reduce corporate tax rates when these controls were abolished as part of the financial liberalisations of the 1990s: "Reductions in [corporate] tax rates can be explained almost entirely by more intense competition generated by the relaxation of capital controls". Countries which keep controls on the movement of capital do not reduce corporate tax rates. (Bartelsmann and Beetsma 2003; Devereuk et al 2008)

The most complete form of escape from taxation is the use of tax havens – countries which impose no tax on corporate profits and also demand very little information from companies registered in their jurisdictions. Tax havens include the UK-owned Cayman Islands, Channel Islands and Bahamas; and the Dutch Antilles. Half of all world trade and financial transactions are carried out through tax havens. The Tax Justice Network, founded to campaign against tax havens, estimates that USD $250billion in revenue is lost each year because of rich individuals holding assets in tax havens. It provides clear summaries of the problems of tax evasion, tax avoidance, tax havens, and 'capital flight'. For lower and middle income countries, these forms of corporate behaviour can seriously undermine developmental potential. (TJN 2011; Somo 2008)

Box B. The Tobin tax, 'Robin Hood tax'

One kind of tax on companies is of great potential benefit. This is the 'Tobin tax', also known as a 'Robin Hood' tax, which is a tax on financial transactions. The tax is called a 'Tobin tax' after the Nobel-prize-winning economist who advocated it as a way of deterring such transactions, and so protecting currencies from the volatility of speculative inflows and outflows. It is now also seen as a great potential source of taxes on international and especially financial corporations. It also has the advantage that it is easy to collect and hard to avoid, especially if it is linked to legal ownership rights.

If applied globally, a financial transactions tax could raise over USD $1trillion per year, or 2% of global GDP, even at a rate of 0.01%. A more limited currency transaction tax could raise between USD $25–33billion per year. (Taskforce 2010)

Political support for the idea, in principle, has been growing for some years. In September 2004 world leaders including Presidents Chirac of France and Lula of Brazil, Prime Minister Zapatero of Spain and UN Secretary General, Kofi Annan, pronounced that: "a tax on foreign exchange transactions is technically feasible". The idea was discussed at a meeting of the G20 in 2009, and has received support in principle from France, Germany and the UK, with the USA ambivalent; the IMF is unenthusiastic.

The tax has the obvious attractions of raising revenue and controlling the most volatile form of financial behaviour. It is discussed as an international tax because of the fears that financial companies would stop operating in countries that introduced it on a national basis, and move to countries which had not introduced such a tax. When Sweden tried to introduce a similar tax in 1990, the volume of trading fell sharply and the tax produced little revenue, so it was dropped. (Beitler 2010)

But there have been a number of cases of countries operating such taxes successfully. The UK has for a long time imposed Stamp Duty on many financial transactions, including a tax of 0.5% on transfers of share ownership, which does not appear to affect dealings on the London stock exchange. It is also international in effect, because it is necessary for legal ownership, so transactions in UK company shares anywhere in the world are taxed.

Financial transaction taxes have also been implemented in various developing countries with some success. Brazil operated a bank debit tax until 2008, which was used to finance healthcare, but it was ruled unconstitutional in 2008. It still operates a currency transaction tax on all capital inflows, at a rate of over 5%, which has the additional effect of controlling any appreciation of the currency. Argentina operates a bank debit tax on buying and selling shares and bonds, which represented 11% of total tax revenue in 2009 (Beitler 2010).

Other international taxes have been proposed as a way of raising revenue to aid developing countries, to bridge the 'resource gap' for financing development and climate change, estimated at USD $324billion per year for the 2011–2015. The main tax being implemented is the Air Ticket Solidarity Levy, charged on passengers flying from participating countries, led by France, which collected €160million for extra French aid in 2009. (Taskforce 2010) There is also discussion of a global environmental tax, to help finance the response to climate change.

2.3 Utilities and local government

Cross-subsidies have always been a common feature of financing utility services. One form of cross-subsidy is by charging a single identical price throughout a country, even though the costs of supplying remote regions are obviously higher than in cities. Public postal services usually operate on this basis. The people in cities are paying more than a market price, and this enables the inhabitants of remote regions to pay less than a market price – the total income to the service is the same, but there is a cross-subsidy. Another form of cross-subsidy comes from charging different prices according to consumption levels – in water services, for example, there is often a low charge for a basic amount of water consumed, and then a higher charge for litres consumed above that level – big consumers are paying more so small consumers can pay less.

There can also be cross-subsidies between business users and households. This has been important historically – companies were deliberately charged more for each unit of electricity, for example, so that households could be charged less, so providing a direct cross-subsidy from businesses to people. This form of cross-subsidy becomes impossible when a service is liberalised, because the big customers can find a new supplier who will sell them electricity at a much lower rate. Pressure from international institutions for 'full cost recovery' also makes it harder to operate cross-subsidies.

Cross-subsidies have also been arranged between services, by providing a number of services through a single municipal company. This arrangement is common in some European countries, such as Germany, where there are many of these municipal companies, known as '*Stadtwerke*'. A company can provide electricity, gas, water, cable TV, public transport services etc., and fix its charges so that the electricity, gas and water services make a substantial profit, which is then used to subsidise public transport, so that low fares can be charged to encourage people to make use of buses and trains. These companies can also cross-subsidise other municipal services – for example parks, cemeteries, public baths – because the municipal owners can use the profits as extra income to finance those services. Municipalities in South Africa, for example, have relied heavily on surpluses from various utilities to finance general services, as can be seen in table 20. This form of cross-subsidy is also made harder by liberalisation and rules on full cost recovery, for the same reason: electricity or gas users can get other suppliers at lower prices, so they no longer contribute towards the overall income of the company.

Utilities can also be financed by tax revenues. For investment in developing water and electricity systems, taxation remains overwhelmingly the largest source of finance. Additionally, governments may decide to use subsidies, to make the price of water or electricity more affordable, for example. Water and sewerage services have often been financed almost entirely through taxation of properties rather than charges for the volume consumed – this makes the burden more progressive, even when the sums collected cover the full costs. In the Republic of Ireland almost the entire service is financed from general tax revenues (the same system is also used in Northern Ireland, part of the UK, despite government attempts to introduce specific water charges). More surprisingly, the same system continues to be operated in England and Wales, even after privatisation: the majority of households continue to be charged on the basis of a tax valuation of their property, regardless of consumption.

Local governments depend not only on their own local tax revenues, but also transfers from central government. The need for this depends partly on the distribution of tax revenues between different levels of government: in the EU for example, on average 52% of tax revenue goes to the central or federal government, 30% to the social security funds, 7% to the state or regional government and 10% to local government. But there is a wide variation between countries, even within the EU.

The types of taxes used and the importance of the different sources of income vary between countries, but some form of property tax is common. Other taxes are possible. Taxation on the use of cars could be more used in developing countries, for example. Car ownership has increased significantly in most developing countries, but taxes on cars do not cover the costs of road networks, parking spaces, and traffic regulation, let alone generate surplus revenues for the development of urban services. This form of tax has other advantages: because car ownership is still concentrated among high-income groups, car taxation is progressive, and its proceeds can also be used to promote public transport – which should not be taxed - which is of greater benefit to the poor.

In all countries local governments rely on central government transferring to local authorities a share of the centrally collected taxes. The size of the transfers may be varied by central government, so that this source of income is uncertain for local authorities. Many countries attempt to set out rules for the size of this transfer, for example by specifying the proportion of a specific tax, such as VAT, which will be transferred; and rules for deciding how this revenue is shared between different authorities. However, central government can still vary the rate of tax.

Simple devolution of responsibilities to local government, without devolving the necessary financial and human resources, limits the ability of local authorities to deliver public services, especially in situations of economic growth and social restructuring. In South Africa, for example, new municipalities have been created, unifying areas that were separated under the old apartheid regime, with the objective of raising standards of services for communities that were previously without. The new constitution says that tax revenues must be divided between central government, provincial government, and municipalities, divided according to a formula based on population and per capita income – so that poorer areas get a higher share of the revenues. But the success of this is constrained because central government is not expanding the financial contribution of central taxes proportionately to the new responsibilities of local government.

Table 6. Percentage of municipal revenue from different sources, 2002

	Local tax revenue	Central government transfers	Other local revenue	Borrowing	Total
Denmark	45	19	34	2	100
Finland	42	22	33	3	100
France	52	29	12	7	100
Italy	28	40	20	12	100
Netherlands	7	57	28	8	100
Spain	32	36	23	9	100
Sweden	59	13	27	3	100
UK	13	64	22	1	100
Russia	13	81	6	-	100

Source: Laughlin and Martin 2006, Chernyavsky 2004

Table 7. Sources of local government finance: South Africa and Botswana

	Year	**Source**	**%**
South Africa	1999	Property rates	19.89
		Trading services elec etc.	41.40

		Water	11.80
		Sewerage, waste disposal	8.22
		Government grants	10.00
Gaborone City Council, Botswana	2000	Rates	27.3
		Interest	2.05
		Service levy	0.95
		Rentals	0.9
		Other sources	6.1
		Revenue Support Grant	62.7

Source: (Mosha 2004/ Parnell et al 2002)

2.4 The politics of tax collection

Making tax collection more efficient is an obvious way of improving the amount of tax collected – and it also makes taxation fairer, by limiting evasion. Technically, it involves improving procedures and resources, and eliminating special treatment, exemptions and privileges.

But there are significant barriers, as rich individuals and corporations resist paying taxes, so more political effort and commitment is required. The IMF's evaluation division highlights the importance of the political effort and commitment, and at the same time criticises the IMF itself for failing to demand action against these powerful interests:

> Stronger efforts should be made at improving collections, curtailing discretionary exemptions, and reducing tax evasion – particularly direct taxes (personal and corporate) and customs duties. Even in the short run, these efforts could yield important revenue increases if targeted at collecting from well-known taxpayers with arrears or those believed to be significantly underpaying. When tax authorities have displayed determination in this area, the results have been impressive and have received wide support. [But] tax administration reforms in IMF-supported programs have focused on the technology side rather than on politically more difficult actions, such as legislation to empower tax agencies to pursue tax evasion forcefully and for the system to be less prone to political interference…" (IMF 2003)

Political commitment and adequate resources make a huge difference to collection levels, even in a country like the UK. In 2009 a report estimated that the country had a total of GBP £21.5 million worth of taxes that were not collected each year, and a further GBP £25 billion lost to tax evasion. Yet the government had cut 7,000 tax compliance jobs in the previous three years, although on average each such job finds an extra GBP £640,000 in tax, and proposed to cut thousands more jobs.

By contrast, in the same year, the finance minister of India announced that the government was increasing the resources it devoted to collecting taxes, using a memorable image for the workers:

> Our tax collectors are like honey bees collecting nectar from the flowers without disturbing them, but spreading their pollen so that all flowers can thrive and bear fruit. (India Budget Speech 2009)

Box C. Municipal tax collection in Brazil and Botswana

Ending exemption

In the city of Belem, Brazil, the municipality needed to find new sources of income to fund its programmes of improved public services. At the same time it was losing income because the state was stopping payments to municipalities of a share of a tax on goods. So in 1998 the city decided to revise the register for property taxes. This had not been fully revised since 1976, which registered 200,000 properties in the city. The new survey, based on aerial photography, identified 360,000 properties – of which 280,000 were homes, and 60,000 were commercial – so the city could collect the tax from far more properties, and so get a much greater income. In order to reduce the impact on the poor, it decided to exempt from the tax all properties worth less than R$19,000, which excluded about 178,000 out of 280,000 properties. The Workers Party still won the next municipal election in 2000. (Baiocchi 2003)

Tightening procedures

Gaborone City Council in Botswana had no clear procedure for following up on people who did not respond to the first demand for local rates. As a result, by 2000, unpaid rates amounted to USD $6.4million (P 32.48million). New measures were then introduced: written notices were sent to all defaulting ratepayers; and reminders were issued to all plot owners who have not paid their full rates within the allowed period of four months reminding them that they will be liable to pay interest and then that they will be taken to court, with possible confiscation of property. The council then published the names of defaulters in the national press. Within a week, the Council received over USD $1million dollars of arrears as companies, individuals and government departments rushed to avoid further embarrassment. The collection of rates is not administratively difficult and it merely requires a highly determined administration to achieve low default rates. (Mosha 2004)

3. Government deficit and debt

Following the 2008 financial crisis and the subsequent recession, the key policy adopted almost universally in 2009 for dealing with the recession was the Keynesian approach of increasing government deficits in order to inject more demand into the economy. This has mainly taken the form of higher public spending by governments – on infrastructure, public services and/or social security benefits (see my article in the last issue of this Journal).

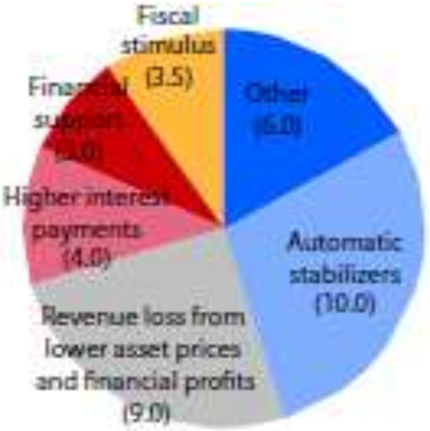
There are now numerous voices arguing that spending on public services should be cut back as soon as possible, in order to reduce the deficits which have arisen as a result of the crisis. The EU is insisting that countries should return rapidly within the EU official ceilings on deficit and debt. This has been reinforced by the bond market activity which undermined the feasibility of Greece, Portugal and Ireland.

But there are a number of problems created by this approach.

In high-income countries as a whole, government debt is forecast to reach about 100% of GDP by 2014 – about 35.5% higher than before the crisis. According to IMF estimates, nearly all of this is the combined result of the recession itself (loss of tax revenues due to the recession; higher interest payments because of increased government deficits) or with government action to counter the recession – the automatic stabilisers, additional fiscal stimulus, and support for the banking sector. Only six percentage points are attributable to 'other' factors. Governments have little influence over the majority of these factors.

Chart E. Composition of Government Debt Increase 2007–2014

Total increase = 35.5% of GDP, of which:



Source: IMF, *World Economic Report April 2010*, Figure 1.7
http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/text.pdf

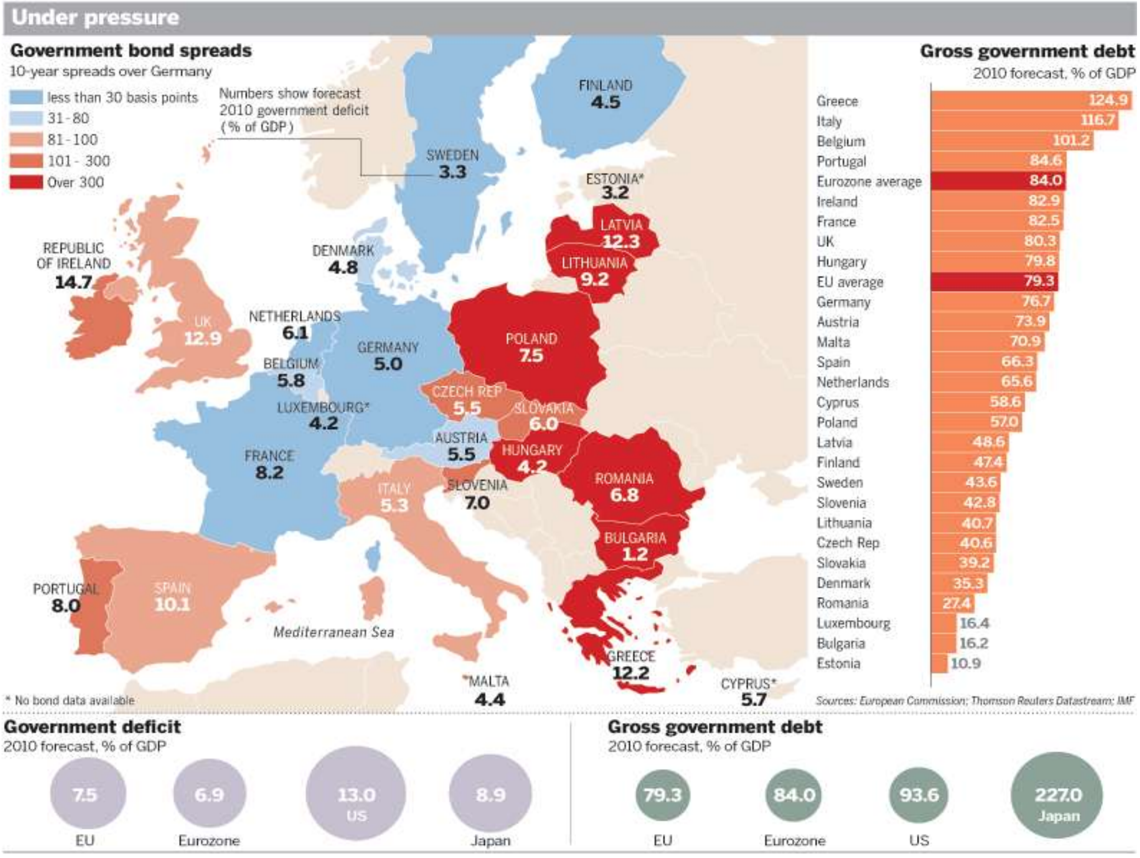
Current policies for limiting government deficits are based on arbitrary figures, such as the EU rule that deficits may not exceed 3% of GDP, and debt may not exceed 60% of GDP. But there is no single magic figure. Much higher levels are sustainable, for example, in the sense that a country could continue with this level of debt and deficit without it getting worse. For example, if the real interest rate paid by the US government on its debt is below 2%, it would only cost 2% of GDP to service a debt of 100% of GDP. If the economy is growing at 4% per annum, then a country with debt of 100% of GDP could manage indefinitely to run a deficit equal to 4% of GDP – both figures way above the EU rules. Historical debt levels have been much higher than current EU rules allow: in the late 1940s, federal government debt in the USA reached 120% of GDP, and in the UK 240% of GDP – yet both countries subsequently experienced healthy economic growth, accompanies by a rapid fall in debt levels as a percentage of GDP - as chart G (below) shows. (Wolf 2009, IMF PFM Blog 2008)

As can be seen in chart F there is a wide range of existing debt and deficit levels – but other factors are more important in deciding what countries have to pay for their borrowing. In 2009 Japan had debt worth 200% of GDP, while Estonia, Bulgaria and Romania all had debt levels of less than 30% of GDP – far below even the EU's ceiling. The deficits of all three countries were also all under 7% of GDP – less than half the level of the USA (13%). Yet Japan and the USA could finance their debt far more cheaply and easily than these three countries. It is also worth noting that when Ireland announced in September 2010 that it would have to increase its deficit by a huge amount in order to rescue a bank, the bond markets did not react against Ireland's bonds at all. To the traders, presumably, increasing government deficit to carry out yet more bank rescues is an acceptable use of government borrowing.

The attempts to cut spending and deficits also risks undermining any recovery in the north. While the global south has already regained healthy annual growth, any signs of recovery in the north (to October 2010) remain heavily dependent on government spending and deficits – personal and corporate spending is barely recovering. As long as this is the case, cutting back public deficits would risk pushing economies back into recession. The deficits are, after all, partly a consequence of the crisis – because of lost tax revenues, the automatic stabilisers – and partly a *deliberate* policy response to the crisis. The FT chief economic correspondent, Martin Wolf, warned in September 2009:

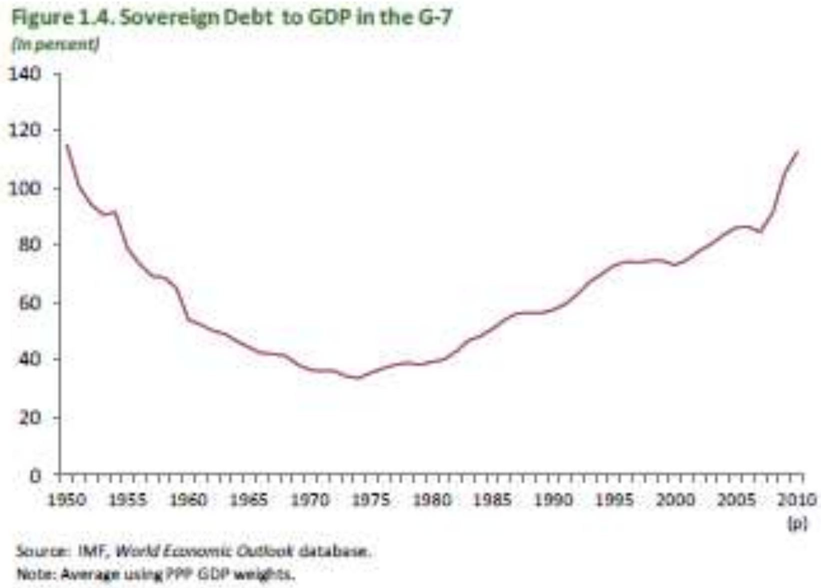
> The rescue of the financial system, unprecedented monetary easing and fiscal expansion (most of the latter being automatic rather than discretionary) have indeed put a floor under the world economy … Now suppose that, instead of keeping calm, the authorities are frightened into premature monetary and fiscal tightening. Given the extreme fragility of the private sector, that could cause another economic downturn. The inevitable result would be another round of emergency fiscal and monetary measures. The point is fundamental: exceptional monetary and fiscal measures are not the root cause of the danger. The weakness of the private economy is at its root. The policy measures are a consequence …(Wolf 2009)

Chart F. Deficit and debt as % of GDP EU countries February 2010


Under pressure
Government bond spreads
10-year spreads over Germany
less than 30 basis points
31-80
81-100
101 - 300
Over 300
Numbers show forecast 2010 government deficit (% of GDP)
FINLAND 4.5
SWEDEN 3.3
ESTONIA* 3.2
LATVIA 12.3
LITHUANIA 9.2
REPUBLIC OF IRELAND 14.7
DENMARK 4.8
UK 12.9
NETHERLANDS 6.1
GERMANY 5.0
POLAND 7.5
BELGIUM 5.8
LUXEMBOURG* 4.2
CZECH REP 5.5
SLOVAKIA 6.0
AUSTRIA 5.5
HUNGARY 4.2
FRANCE 8.2
ROMANIA 6.8
ITALY 5.3
SLOVENIA 7.0
BULGARIA 1.2
PORTUGAL 8.0
SPAIN 10.1
Mediterranean Sea
GREECE 12.2
*MALTA 4.4
CYPRUS* 5.7
* No bond data available
Gross government debt
2010 forecast, % of GDP
Greece 124.9
Italy 116.7
Belgium 101.2
Portugal 84.6
Eurozone average 84.0
Ireland 82.9
France 82.5
UK 80.3
Hungary 79.8
EU average 79.3
Germany 76.7
Austria 73.9
Malta 70.9
Spain 66.3
Netherlands 65.6
Cyprus 58.6
Poland 57.0
Latvia 48.6
Finland 47.4
Sweden 43.6
Slovenia 42.8
Lithuania 40.7
Czech Rep 40.6
Slovakia 39.2
Denmark 35.3
Romania 27.4
Luxembourg 16.4
Bulgaria 16.2
Estonia 10.9
Sources: European Commission; Thomson Reuters Datastream; IMF
Government deficit
2010 forecast, % of GDP
7.5 EU
6.9 Eurozone
13.0 US
8.9 Japan
Gross government debt
2010 forecast, % of GDP
79.3 EU
84.0 Eurozone
93.6 US
227.0 Japan

Source: *Financial Times* February 9 2010 'Investor headwinds lash Euro solidarity', by Ralph Atkins in Frankfurt and Chris Giles in London

Chart G. Trends in public debt as percentage of GDP, G7 countries, 1950–2015



Source: IMF *Global Financial Stability Report April 2010* Figure 1.4
http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/text.pdf

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