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Double Jeopardy: Globalization, Liberalization and the Fiscal Squeeze

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Summary. — The liberalization policies that underpin a globalizing world often have costly repercussions on public budgets at the national and subnational levels. These costs are of two kinds: additional spending requirements (to adjust societies to fast economic change), and challenges to resource mobilization. The cumulative effects of these challenges put public authorities in a double bind: as public spending needs increase with globalization, their capacities to raise revenue weaken. The ensuing "fiscal squeeze" poses yet another dilemma: either running a fiscal deficit and paying the macroeconomic price, or cutting spending, which could jeopardize social cohesion and competitiveness itself. © 1998 Elsevier Science Ltd. All rights reserved

Key words — globalization, liberalization, fiscal policy, tax reform, south east Asia, Thailand

1. INTRODUCTION

Globalization is forcing a reinvention of the relationship between the private and the public sector. Nowhere is this more apparent than in the fiscal realm. Indeed, public budgets operate at the interface between the private sector (the purveyor of funds via taxes) and the public sector — the purveyor of common services. In most countries, public finance is also the main instrument for maintaining a social contract, and in particular for ensuring that the wealth created by the private sector "trickles down" to those that are bypassed in its normal operation. Taking a closer look at changes in public finance worldwide is thus a good avenue for understanding the effects of globalization and for understanding the new, emerging structures of the international political economy. Based on an analysis of emerging trends, this paper will attempt to substantiate a "fiscal squeeze" model of the effect of globalization, and will outline avenues for further, more systematic assessment of the phenomenon. Rather than "globalization", the paper uses "liberalization" as the independent variable, since the latter draws attention to the *policy* dimension of the phenomenon, as opposed to globalization, which could pass as a spontaneous development. One starting point is, that "globalization" is largely occurring as a result of conscious decisions to liberalize cross-border transactions in money, goods, services, people and information. The "squeeze" hypothesis will be illustrated with reference to two simultaneous phenomena — pressure on the spending side, and pressure on the revenue side. Finally, the paper analyzes distributional implications by using the example of the recent currency crises in South East Asia.

2. DECLINING RESOURCES FOR PUBLIC BUDGETS

(a) *Fiscal retrenchment: choice or constraint?*

Are states (and public authorities at subnational levels) now faced with dwindling resources, for example in the form of tax receipts? Historical data on public finance present a mixed picture, with government revenue as a percentage of GDP declining on average in LDCs and growing slightly in developed countries. The average decline in governmental receipts in developing countries since the early 1980s seems to be a result of structural adjustment policies, which sought to

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shrink the share of the public sector in those economies (see Table 1).

By contrast, the size of the public sector has slightly increased in developed countries, though at a slower rate than in the 1960s and 1970s (see Table 2).

Cutbacks in public spending owe much to a willingness, since the early 1980s, to restore the place and role of the private sector in development, and especially to supply-side measures including tax cuts, motivated by the search for a return to non-inflationary growth. The retreat of the state is also due to macroeconomic constraints, leading governments to reduce or contain their overall levels of spending. This concern is due to a variety of circumstances: the external debt overhang in developing countries, restricting access to external credit, and therefore flexibility in fiscal matters; mounting interest payments on the national debt in both the North and the South; and in transition economies, a concern for broader macroeconomic balances, deemed crucial in effecting the transition to a market economy.

The contemporary concern with fiscal balance, and how it relates to dominant economic strategies since the 1980s, is well known. Fiscal balance is a crucial part of "getting the fundamental rights", or "sound macroeconomic management". Yet, fiscal positions are too often thought of as determining other economic outcomes, rather than as being determined by them — as exogenous causes, rather than consequences. The exogeneity assumption is often due to the prevailing philosophy, according to which the main determinants of fiscal positions is either

Table 1. *Total government revenue in developing countries as a proportion of GDP*

	1980–81	1986–87	1988–89
Developing Countries	21,4	20,6	20,4
Latin America	21,1	21,8	21,3
Asia	19,7	18,7	18,5
Sub-Saharan Africa	19,7	19,3	19,1
Other African and Middle East	38,1	29,5	29,7
Developing Countries outside Africa	22,9	21,7	21,5
Low-income developing countries	16,5	16,0	16,0
Intermediate income developing countries	25,0	23,7	23,3

Source: Chambas (1994), compiled from IMF, UNDP, French Ministry of Cooperation.

Table 2. *Total G-7 receipts and outlays as a percentage of GDP, 1979–93*

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Total Receipts															
United States	30.3	30.5	31.1	30.5	29.9	29.7	30.1	30.2	31.0	30.5	30.9	30.8	30.7	30.7	31.1
Japan	26.3	27.6	29.0	29.4	29.6	30.2	30.8	31.0	32.6	33.1	33.4	34.6	34.4	33.8	32.9
Germany	44.6	46.0	45.0	45.7	46.3	46.5	45.8	45.0	44.8	44.1	44.9	43.0	44.6	45.7	46.1
France	44.1	46.1	46.1	47.6	48.2	49.2	49.3	48.6	49.0	48.3	47.9	48.3	48.3	48.2	48.8
Italy	31.5	33.3	33.3	36.2	38.0	37.7	38.3	39.1	39.2	39.6	41.4	42.2	43.3	44.1	47.3
United Kingdom	37.7	39.6	39.6	42.1	41.4	41.3	41.2	40.0	39.3	38.9	38.4	38.7	38.2	36.9	35.8
Canada	35.3	36.1	36.1	38.8	38.4	38.5	38.5	39.2	39.7	40.0	40.3	41.9	42.6	42.8	42.1
G-7 aver. receipts	35.7	36.9	37.2	38.6	38.7	38.9	39.1	39.0	39.4	39.2	39.6	39.9	40.3	40.3	40.6
Total Outlays															
United States	29.9	31.8	32.1	33.9	33.9	32.6	33.2	33.7	33.4	32.5	32.4	33.3	34.0	35.0	34.5
Japan	31.1	32.0	32.8	33.0	33.3	32.3	31.6	32.0	32.2	31.6	30.9	31.7	31.4	32.3	34.3
Germany	47.2	47.9	48.7	49.0	47.8	47.4	47.0	46.4	46.7	46.3	44.8	45.1	47.9	48.5	49.6
France	45.0	46.1	48.6	50.3	51.4	51.9	52.1	51.3	50.9	50.0	49.1	49.8	50.5	52.2	55.0
Italy	41.6	41.9	45.9	47.6	48.7	49.3	50.9	50.7	50.2	50.3	51.3	53.2	53.5	53.6	56.9
United Kingdom	40.9	43.0	44.2	44.5	44.7	45.1	44.0	42.4	40.7	37.9	37.5	39.9	40.7	43.0	43.6
Canada	37.3	38.8	39.8	44.8	45.3	45.0	45.3	44.6	43.5	42.5	43.1	46.0	49.2	50.2	49.4
G-7 aver. outlays	39.0	40.2	41.7	43.3	43.6	43.4	43.4	43.0	42.5	41.6	41.3	42.7	43.9	45.0	46.2

Source: OECD (1995a, b).

political, or institutional (Alesina and Perotti, 1995, pp. 799–821; Alesina and Perotti, 1996, pp. 401–407; Poterba, 1994, pp. 799–821; Crain and Miller, 1990, pp. 1021–1046). This has led to the neglect of other, economic determinants of fiscal balances, and to the question of how policy can affect them. This neglect is paradoxical, because political debates in many countries are dominated by the themes of powerful fiscal constraints. Yet, the dominant strand of the scholarly literature attributes fiscal deficits primarily to the discretionary power of politicians.

In this section, we will document trends related to liberalization and the ensuing globalization that pose new challenges to securing financial resources for the public sector.

(b) *Trade liberalization*

Efficiency objectives, as well as multilateral commitments, have led many developing countries to reduce trade taxes, in particular import taxes. Scaling down protectionism was part of broader structural adjustment measures aimed at encouraging individual economies' competitiveness and at reducing rent-seeking behavior. Foreign trade taxes, however, have always been a privileged revenue-raising device for developing countries — where they account for up to one-third of tax revenue (See Table 3) — and even for industrial countries at earlier stages of development such as the United States in the 19th century. The reason is that trade taxes are easier to implement, and do not require complex administrative systems. Indeed, it has been estimated that the administrative cost of levying trade taxes amounts to 1–3% of collected revenue, versus up to 5% for value-added taxes and up to 10% for income taxes (World Bank, 1988). Ending protectionism in its traditional form has had, therefore, costs in terms of forgone revenue, which must be budgeted for, even if the resulting, increased growth should make up for part of these losses in the long term.

Consequently, even countries that are committed to liberalization measures have found their resolve falter in view of the fiscal implications. In Chile, a plan for a two-stage reduction in import tariffs, from the current 11%, down to 8%, was postponed because of concern for the expected loss of public revenue — the anticipated losses are being estimated at $420m, with Parliament failing to agree on who should bear the burden of the extra taxes or budget cuts that this shortfall would necessitate (*Financial Times*, 1997b, 5 August, p. 5).

In Colombia, the reduction in tariffs and surcharges in the context of the 1992 tax reform cost the Treasury around 130 billion Colombian pesos, or about one-fifth of the governmental deficit.[1] Estimates for Morocco have shown that trade liberalization would lead to a shortfall equivalent of up to one-quarter of governmental revenue. Unless alternative revenue is levied, a Report warns, the additional deficit could increase Morocco's external debt, leading to higher interest rates (if inflation is to be avoided), with possible crowding out of private investment and adverse effects on growth (Tapinos, 1994).

While trade taxes entail lower administrative costs, they do lead to welfare losses larger than most other forms of taxes — a reason why liberalization has been widely pursued. In theory, the enhanced welfare and additional resources can be used to compensate the losers of liberalization, while still leaving the economy as a whole better off. If compensation is well designed and implemented, no one should lose — making the change Pareto-superior. In practice, however, the growth and efficiency gains resulting from liberalization have not been high enough to garner additional revenue, or even to achieve

Table 3. *Trade taxes as a percentage of total government revenue*

	1975	1980	1985
Export taxes			
Industrial countries	0.24	0.13	0.04
Middle-income countries	3.94	3.08	1.30
Low-income countries	11.40	10.18	7.99
Import taxes			
Industrial countries	3.71	2.61	1.58
Middle-income countries	20.23	20.06	17.04
Low-income countries	25.17	27.67	28.50

Source: Linn and Wetzel (1990).

fiscal neutrality. In some instances, such as Thailand in the mid-1980s, the revenue shortfall of trade reform has led to unsustainable imbalances and a reversal of liberalization policies (Linn and Wetzel, 1990, p. 18).

(c) *Financial liberalization*

The liberalization of a country's external account and the lifting of regulations governing financial transactions have led to both revenue shortfalls and spending increases. Financial liberalization has created a revenue shortfall because, in the course of regulating interest rates or steering money and credit to various sectors of the economy, governments occasionally make a profit, or are able to borrow at subsidized rates. For example, commercial banks are frequently required to hold government securities at below-market rates, or are asked to deposit non-interest bearing assets with the Central Bank. Estimates of governmental revenue from such regulations are substantial: in Mexico, for example, controls on financial markets amounted to a revenue of close to 6% of GDP during 1984–87, or about 40% of total tax revenue — gains that are decreasing with financial liberalization. The total revenue from what is sometimes referred to as "financial repression" (implicit taxes on domestic financial markets as a result of controls in international capital flows or domestic financial intermediaries) has been estimated on average at 9% of total government revenue, or 2% of GDP (Giovannini and de Melo, 1993, pp. 953–963).

International financial liberalization has also contributed to the demise of inflation and, hence, led to curtailments in "seignorage" revenue. As governments tighten the money supply, money creation and, hence, seignorage, decreases. Governments also lose revenue from a disappearing "inflation tax" — the ability to repay investors in devalued currency. The loss of purchasing power of governmental assets held by the private sector as a percentage of GDP has decreased from 2.7 to 1.7% during 1983–89 and 1990–95 in developing countries with large fiscal deficits, and from 3.5 to 2.8% in developing countries with moderate fiscal deficits (IMF, 1996c, p. 71). In fact, bond holders, wary of the inflation tax, now require higher rates on governmental debt when inflation threatens.

Certainly, the disappearance of inflation *per se* may be worth these earning shortfalls. Yet, there is suspicion that global capital mobility creates a policy environment that is growth-constraining (Eatwell, 1997). Moreover, low growth usually produces fiscal deficits. In times of slower growth or recession, private sector profits fall and tax revenues dry up, while governmental spending rises, in the form of unemployment benefits and means-tested benefits. Conversely, growth boosts governmental income and reduces outlays.

Another forgone source of revenue through monetary reform originates in the phasing out of capital controls in the form of multiple exchange rates: the sale of foreign exchange at higher than market rates used to be a source of revenue for governments, if they were net sellers of foreign exchange. Liberalization and devaluation often lead to a unification of exchanges rates, removing yet another source of revenue (Reisen, 1990, p. 89).

Currency devaluation, a widely-adopted structural adjustment measure aimed at boosting the export sector and increasing the demand for tradeable goods, also has a role in compounding fiscal difficulties by increasing the value of the foreign debt and its servicing costs, expressed in domestic currency (Tanzi, 1990, p. 3). A redistribution of sorts occurs between the private and the public sector as a result of devaluation at the expense of the latter since, in seriously indebted countries, much of the foreign debt is held by the public sector, while most export earnings and foreign assets are held by the private sector. Moreover, devaluation was traditionally thought of as boosting tax income in developing countries, because it raises the price of imports, and therefore revenue from import taxes. Yet, in many countries, as discussed above, trade taxes are being phased out.

Devaluation will also lead to a loss of fiscal revenue in countries with heavy reliance on wage taxes, and will increase revenue in countries that rely on capital gains taxes. Hence, for countries that are following the trend toward "modern" tax structures of low trade taxes and low capital-income taxes, devaluation can lead to income losses (Seade, 1990, p. 64). As a "package" then, structural adjustment programs tend to have adverse effects on tax receipts.

(d) *The globalization of the tax base*

Globalization means that an increasing portion of the world's economic activity is carried out across borders. Even in times of economic slowdown, or when analysts worry about protectionist tensions, the rate of growth of world trade has consistently been superior (often, double) that of world growth. Foreign direct investment grew by almost 50% during 1993–95, and again by 10% in 1996, according to UNCTAD's *World*

Investment Reports of 1995 and 1996 (UNCTAD, various). In 1970, a typical large US company earned 10–20% of its income from abroad. Now, many earn at least half their profits outside the United States (*The Economist*, 1997, 31 May). Yet, most tax systems were designed at a time when economies were primarily domestic. The fact that a small proportion of wealth originated from outside could be accommodated "at the margin", through additional provisions within these systems. It is an approach that is less and less effective, though.

First, taxing foreign income poses a tradeoff between progressivity and revenue objectives. If one is concerned with progressivity, adopting a residence principle is best — foreign income is treated as domestic income, and taken into account in calculating the applicable tax rate. In practice, however, foreign income is very difficult to track. Despite the spate of tax treaties seeking to improve information exchange by administrations, practical difficulties abound, starting with language, difficulties in decoding foreign tax documents, lack of actual cooperation at the operational level, legal challenges, and even competitive behavior among countries (Tanzi, 1990, pp. 79–89). In practice, foreign income often means evaded income.

Hence the alternative, the source principle, is often adopted — mostly for corporate taxation. Yet, in that system, transfer pricing and other tax planning techniques often distort credit reporting at the source. Intrafirm transfers in the form of loans or intrafirm trade at non-market prices seek to make profits appear in the lowest-taxed jurisdiction. The deposit of patents or the location of administrative or research activities also seek to play off high-taxing against low-taxing countries. Empirical studies have shown that firms posted a higher rate of return, on average, in low-tax countries than in high-tax countries — a behavior known as income shifting (Tanzi, 1995, p. 103). According to Ernst and Young, more than 80% of existing multinational companies have been in dispute with tax authorities over transfer pricing (*Financial Times*, 1996a, 5 January, p. 3). In 1992, tax audits of multinational companies by the US Internal Revenue Service resulted in penalties in more than half the cases — for a total of $1.3 billion. In addition, transfer prices for companies operating in and out of the European Community concerned transactions worth more than ECU 300 billion in 1990 (Conseil des Impôts, 1994, pp. 321 and 300).

The rise of electronic commerce is also posing fresh challenges to revenue collection, drastically accelerating the globalization of the tax base by providing easy access to international customers and suppliers, and making it more difficult to assess and collect value-added tax on transactions that occur over the Internet. Yet, VAT and consumption taxes account for about 30% of governmental revenue in OECD countries — and more in developing countries. Use of the Internet by global firms is also changing the way subsidiaries work with each other, which affects the way transfer prices rules are applied, and also complicates the audit trail. Finally, electronic networks will make tax havens and offshore banking within reach of a larger number of firms and individuals.[2]

The scope of the challenges is difficult to assess empirically, in part because Treasuries are trying to make up the shortfall by increasing taxes on other, immobile factors such as land or labor. In the European Union for example, payroll taxes have increased by 20% during 1980–93, while capital gains tax receipts have fallen by 10% (*Financial Times*, 1996b, 21 March, p. 2) — which poses problems of its own.

The impending challenge to revenue has prompted some US Treasury officials to contemplate radical new approaches to the taxation of international income, in the form of formula apportionment — a system that would use a firm's worldwide income as a base for taxation, and then divide the proceeds between host countries according to an agreed formula. Other officials are studying a tax on information units traveling over the Internet.

(e) *Tax competition*

When policymakers try to cope with these challenges in a "beggar-thy-neighbor" fashion, problems are compounded. With capital tending to prefer low-tax environments, states are engaging in a competition to lower corporate and capital gains taxes, resulting in overall shortfalls in tax receipts. With tax competition comes fiscal degradation. It is often thought that this problem mainly affects small, open economies, that are unable to maintain independent fiscal policies. Yet, the influence of the 1986 US Tax Reform on all OECD countries is well documented. It triggered a string of reforms aimed at emulating the original US changes, along the following lines:

1. base broadening — which consisted in removing tax privileges and exemptions, but also in including low-income families in the tax base.

2. reduction of top and high rates: in all OECD countries except Switzerland and Turkey, the top income tax rate has fallen, sometimes by more than a third, and the OECD average tax rate for that bracket fell from 54 to 42% during 1985–90.
3. fewer brackets, reducing progressivity.

The effect on progressivity is compounded by an emphasis on broad-based consumption taxes, rather than income taxes.

Tax competition is in part responsible for what has been characterized as "a general fall in tax rates for both individuals and corporations" (Tanzi, 1995, p. 74). In the British Commonwealth, for example, out of 35 countries which had an individual income tax prior to 1990, 29 had reduced their rates by 1990, and none had increased it. In some instances, though, tax reform was made revenue-neutral by offsetting changes, such as smaller deductions for businesses, or changed depreciation deductions.

Tax competition also affects subnational authorities — for example, regional or municipal budgets. In the United States, the Corporation for Enterprise Development estimates that state and local governments forego $5 to 8 billion every year in tax incentives, most of them property tax abatements. The effects on schools is starting to be felt, since schools generally receive almost half of all property tax revenues (*New York Times*, 1997, 21 May, p. 8). A sharp fiscal competition is currently developing in Brazil, among various states and even among cities within these states. For example, the state of Alagoas extended a standing offer to business to match any offer by Ceara, another north-eastern state. Soon enough, the competition took its toll on public budgets. Alagoas went bankrupt after not paying its teachers for eight months, and Ceara endured a violent rebellion of its underpaid, demoralized police forces (*The Wall Street Journal*, 1997, p. 1).

In developing countries, tax-exempted export processing zones compete with each other and with the hinterlands. Yet, it is primarily in these zones that new wealth is being created — new wealth that will not feed public coffers. In Thailand, a proposed rebate scheme for taxes on export production was calculated to have entailed a cost of between 0.3 and 0.6% of GDP (Bhattacharya and Linn, 1988). India's 1988–89 budget included measures to strengthen exports by granting a 100% exemption on export profits (OECD, 1990, p. 25). Yet, rebates for export companies are often difficult to implement, and generate fraud and distortions between competitors (Chambas, 1994).

In addition, in a world a free capital movements, non-identical capital tax rates create distortions leading to a net loss, not only of tax revenue, but of world welfare. This is because capital fails to flow to areas of maximal pre-tax returns, but instead is allocated according to expected post-tax returns.

(f) *The growth of the informal economy*

Another variable could mediate between globalization and the fiscal crisis of states — the weakening of administrative capabilities in many countries, and the shrinking of the "law-abiding" sphere in many economies.

Estimates of the scope of tax evasion vary, but seem to record an upward trend. In OECD countries, estimates of the untaxed economy ranged from 6.2% to 11% of GDP in 1978, while a more recent estimate for the European Union cited 25% of GDP (Weck Pommerehne and Fray, 1984; *Financial Times*, 1996f, 18 October, p. 2). A recent European Union Report estimated at $77 billion the cost of international fraud in the region — criminal activities that are made easier by the relaxation of border controls, the availability of tax heavens, and the differences in legal regimes (Deloitte and Touche, 1997).Concerning developing countries, a study quoted in the 1988 World Bank *World Development Report* evaluated the unrecorded and untaxed economy in India at around one-fifth of GDP, with comparable rates for Chile, Colombia, Kenya and Nigeria provided by earlier studies conducted in the 1960s and 1970s. This may have been quite optimistic. A 1980 study of Indonesia estimated tax evasion at 84–94% of income tax, and 76–93% of corporate tax. In Pakistan, the size of the clandestine economy is believed to equal Pakistan's gross domestic product of $65 billion. Six hundred thousand of the country's annual market of 700000 television sets are allegedly smuggled, and so is almost one half of the tea consumed in the country (*Financial Times*, 1997b, 5 August, p. 5).

In Russia, difficulties in tax collection have taken an unusual saliency and political resonance lately, with millions of soldiers, teachers, health professionals and other public employees failing to receive wages. It is estimated that current tax income is running at less than half what it would be if tax laws were implemented (*New York Times*, 1996, 17 October, p. 26). Desperate for funds, the government instituted a new import tax — confirming that trade taxes are the last recourse when all else fails (*Financial Times*,

1996d, 7 August, p. 2). China is also witnessing fiscal degradation — its tax revenue fell to 11.3% of GDP in 1995 from 12.4% the previous year, despite healthy growth and a tax reform aimed at improving collection (*Financial Times*, 1996c, 25 June, p. 6).

Worldwide, the growth of the criminal economy is a matter of increasing concern. The UN World Drug Report of 1997 estimates that the global drug business generates $400 billion in revenue — equal to 8% of all international trade, and comparable to the annual turnover in textiles. Organized crime in Russia is estimated to generate $900 million a year (*Financial Times*, 1997a, 14 March, p. 3).

The increasing difficulties associated with mobilizing revenue are well analyzed in the case of sub-Saharan Africa. The shrinking of the tax base in many of the region's countries is due to negative growth rates and the decline of the sectors that have so far provided the bulk of tax revenue — the commodity export sector, and the formal sector. As the formal sector is being asked to bear most of the taxation burden, it encounters difficulties due in part to the competition of an expanding, untaxed informal sector. In addition to the informal sector, the so-called fraudulent sector is comprised of large, profitable enterprises that escape taxation through political favoritism. The crisis of the state is thus visible both in the administrative inadequacy of tax administrations (made worse by budgetary constraints), and in the fact that political institutions are vulnerable to influential interests (Chambas, 1994). This is apparent in the large number of tax exemptions and tax loopholes, that often outlive successive regimes, and frustrate reform (*Financial Times*, 1996e, 4 October, p. 8). A less efficient public sector in turn means that development assistance, which often relies on national execution, becomes less productive (UNDP, 1994).

In a way, the efficiency of tax administrations is the litmus test for the health and standing of public authorities in any country. Given the large sums of money involved and the temptation to cheat, the loyalty of officials in tax administrations is particularly vulnerable. Taxes also rely to some degree on societal cooperation and, hence, legitimacy. According to some analysts, the latter factor is an important source of Russia's current tax crisis — which is compounded by tight monetary policy resulting in barter and *ad hoc* monetary instruments, and by problems of institutional transition.[3] In other words, given the sensitive nature of taxation, any degradation in the effectiveness, authority and legitimacy of the state will have bearings on tax collection. The present destabilization of many countries, fueled by ethnic tensions, separatist claims or economic distress, amounts to a "crisis of the state" that has visible repercussions in the fiscal area.

3. INCREASED DEMANDS ON PUBLIC FINANCE

Apart from making it more difficult for governments and local authorities to collect revenue from the private sector, liberalization and globalization also increase the need and demand for public spending — forming the second half of the hypothesized "double jeopardy" on public finance. These new spending requirements are due to states' attempts to discharge their traditional functions in a new environment, or to new tasks that are being assigned to them as part of the redefinition of the role of the state in a global economy.

(a) *Demands arising from fast economic change*

Globalization offers societies the following bargain: the promise of more wealth in exchange for the readiness and willingness to change, adjust, be alert, move people, money and resources in and out of various activities, geographic locations, and industries. An obvious consequence is the enhanced need for training, re-training, and acquiring the basic skills that make such flexibility possible. Societies in which the public sector has taken a leading role in helping to churn out generations of quality engineers and managers will be better off than those without the vision, resources or long-term commitment to build an appropriate skill base. It is widely thought, for example, that the current economic trouble in Malaysia and other "new tigers" is due to skill shortages that helped drive away investments in higher value-added goods. With a shortage of engineers to service the increasingly sophisticated production there, engineers' salaries have increased by about 15% over 1996–97, more than productivity gains (*Financial Times*, 1997c, 20 August, p. 3). Education, both in coverage and in quality, is thus a key element in riding the waves of global competition — yet it means a significant commitment on the part of the public sector.

Moreover, as economies reshuffle resources, human and otherwise, at an increased speed, there is an enhanced need for safety nets to cater

to workers caught in the transition. The NAFTA Treaty, for example, was accompanied, in the United States, by a new fund to provide compensation, relocation and retraining assistance to workers that would be laid off as a result of the migration of business to Mexico or Canada. A recent study found that income losses for displaced workers, even those who find new jobs in similar firms, averages 25% per year (Jacobson et al., 1993, pp. 685–709). To make up for the shortfall, not only unemployment insurance, but all forms of means-tested assistance (nutrition, housing, schooling benefits, etc.) will be called upon. This is the main explanation for a long-standing correlation between economic openness and the size of the public sector. Small, open economies such as the Netherlands or Belgium have always had more comprehensive welfare states and higher government spending than large, more self-sufficient economies such as the United States or Japan. The correlation, represented in Figure 1 in the Appendix, also holds for developing countries (Rodrik, 1996; Cameron, 1978)

Globalization does not necessarily create unemployment *per se* (as a matter of fact, it may create labor shortages in countries such as Malaysia), but it enhances sectoral and geographical mobility, increasing demands for publicly-sponsored goods and services such as social insurance, education, but also urban infrastructure, sanitation, police, public transportation, and rural infrastructure and telecommunications. Urbanization trends, for example, are documented in Table 4.

Coincidentally, social expenditure on welfare seems to have increased over time, even in those countries with no significant aging of the population (see Table 5). Although the private sector is increasingly becoming involved in providing these services, the need for secure, long-term finance often requires public outlays or guarantees. When public services and basic infrastructure are left up to the private sector, as in Southeast Asia, they are commonly undersupplied.[4]

Likewise, informal or private forms of social insurance based on family or community support increasingly fail to reach those in need because geographic and social mobility is stretching traditional support networks. Again, public finance is often called upon to make up for the shortfall — recall that in England, the industrial revolution was contemporary with the advent of the institutionalization of poverty relief — the Poor Houses. A global economy requires stronger states.

Table 4. *Urbanization (proportion of the population living in cities)*

	1960	1994
North America	70	76
Eastern Europe and the CIS	47	66
Western and Southern Europe	64	75
Nordic countries	61	77
All developing countries	22	37
World	34	45

Source: UNDP (1997).

Table 5. *Social expenditure and welfare as a percentage of total expenditure, selected countries, 1990 and 1995*

	1990	1995 (or latest year as noted)	
Middle East			
Egypt	12.89	10.96	(1993)
Israel	23.01	25.45	
Jordan	14.67	14.29	(1994)
Africa			
Botswana	0.66	3.78	(1993)
Ethiopia	4.49	6.90	(1992)
Ghana	7.23	7.10	(1993)
Madagascar	2.37	2.63	
Mauritius	12.99	16.54	
Morocco	5.41	5.92	(1992)
Tunisia	14.19	13.90	
Zambia	1.33	3.21	
Asia			
Korea	9.02	10.52	(1996)
Malaysia	3.71	8.28	(1996)
Philippines	1.63	3.06	(1993)
Singapore	2.11	2.86	(1994)
Sri Lanka	13.14	18.08	
Thailand	3.60	3.74	
Europe			
Bulgaria	22.01	25.32	
Denmark	38.58	43.22	
Spain	38.53	39.59	(1993)
United Kingdom	27.54	31.12	
Americas			
Argentina	45.84	54.70	(1992)
Brazil	25.27	27.14	(1993)
Chile	35.44	33.49	
Colombia	6.53	7.82	(1993)
Costa Rica	13.79	19.95	
Mexico	12.39	22.85	(1994)
Paraguay	11.63	16.25	(1993)
United States	25.56	29.23	

Source: IMF (1995, 1996a).

(b) *Trade liberalization and the "new protectionism"*

Apart from the effects of rapid social change induced by liberalization, economic and industrial change also result in higher spending when public authorities are called upon to make up for the effects of higher competition by providing subsidies to ailing firms or sectors of the domestic economy — or helping exporting firms in their struggle for global competitiveness. The "new protectionism", based on bail-outs, subsidized credit, preferential tax treatment has this disadvantage over the "old protectionism" that it is no easy source of revenue — on the contrary, it is quite expensive.

Subsidies and transfers are the two main culprits in the generation of fiscal deficits in OECD countries in the last 10–15 years. A recent OECD report recorded an increase in industrial subsidies programs in member countries, from 879 in 1989 to 1552 in 1993, with nominal costs rising from $39 to $49.3 billion in the same period (OECD, 1996). The Belgian government, for example, was recently chastised for paying $360 million in aid to domestic companies most exposed to international competition. The aid took the form of lower social security contributions and lower payroll taxes (*Financial Times*, 1996g, 4 December, p. 3). "Corporate welfare" in the United States was estimated to cost around $85 billion a year in 1995 — as compared to a $200 billion deficit the same year.[5] A typical export-promotion measure is the Department of Agriculture's $110 million a year programme aimed at subsidizing the advertising of US brands abroad. In Germany, subsidies increased from DM108.3 billion in 1995 to DM115.2 billion in 1996 (*Financial Times*, 1997e, 29 August, p. 2). Another study has estimated at FF 130 billion total producer subsidies to French-based firms from all three levels of government — local, national, and European. This figure comes dangerously close to the amount of net corporate taxes collected the same year — FF 131.6 billion (*Le Monde*, 1997). Globally, the top 500 multinational companies have all received governmental subsidies at one point or another, and many could not have survived without them (Ruigrok, 1996).

Producer subsidies in developing countries, often induced by liberalization, also amount to substantial budgetary costs. In India, such concerns have bearings on current debates about reducing tariffs on imports of foodstuffs. As the chairman of the Commission for Agriculture Costs and Prices, Abhijit Sen, noted, if tariffs are dismantled, "the Commerce and Finance Ministries will have to intervene with a stronger package of subsidies. But is there money for that?" (South-North Development Monitor, 1997, p. 4)

The increasing reliance on subsidies point to the fact that the policy instruments in the competition for world market shares (and in the struggle to cope with the consequences of this competition) have changed from being revenue-generating — principally import taxes, to being revenue-costly. Export subsidies and other industrial subsidies threaten, however, to leave everyone worse off, in particular public budgets. Another version of competitive subsidies, described below, are those aimed at promoting investment in a particular region or country.

(c) *Investment incentives*

Faced with unemployment and declining economic activities in certain sectors or regions (in the case of developed countries), or seeking to attract capital to boost growth (in developing countries), public authorities are increasingly luring investment capital with various incentives. This phenomenon has been discussed earlier under the broad notion of tax competition, but may also include specific bounties or rebates that are negotiated on a case-by-case basis, auction-like. For example, a US survey of financial officers at major companies operating in the US revealed that 73% said they were more likely to be offered investment incentives today than five years ago (*New York Times*, 1995, 21 September, p. 4). This has led to calls for "subsidies disarmament". In France, economic aid to business from local authorities grew by 22% during 1990–91, excluding loan guarantees (Arthuis, 1993, pp. 155–156).

Apart from being costly to public budgets, investment incentives often benefit mostly large and more profitable firms, as a Mexican study suggests (OECD, 1990, pp. 66–67). They may even tend to encourage short-term investments, if the recipient does not believe that the measure will be sustained.

The increasing recourse to competitive investment incentives, whether in the form of tax rebates or subsidies, has been fueled by many factors: an increasing reliance on the private sector for economic development; the "quick fix" appeal of financial incentives, which are easier to put into place than structural changes such as improvements in governance or the judicial system; the mobility of investors, fueled in part

by investment deregulation and enhanced ease of exit; and the lack of a strong regime for "subsidies disarmament".

(d) *Financial liberalization*

Financial liberalization and the monetary volatility it may entail have also clashed with other governmental objectives such as maintaining stable currencies, or resisting over-valuation, creating additional costs for national Treasuries. These expenses are mounting with the increasing currency volatility in developing countries and the growing attractiveness of investments in emerging markets. In Jamaica, Central Bank losses from exchange rate guarantees exceeded 5% of GDP in the early 1990s (IMF, 1996c, p. 67). In situations where capital inflows are sterilized to avoid currency appreciation, open-market operations usually lead to losses for the Central Bank — of up to 1% of GDP a year in some Latin American countries such as Chile or Colombia.[6] Sterilizaation almost always entails losses for Central Banks because they purchase foreign securities which bear a lower rate than those they issue in return in the domestic currency.

As the productive and banking sectors of the economy are being increasingly privatized, the roles of governments are being redefined — they become guarantors, rather than hands-on economic agents. Yet, in an increasingly volatile world, this role is becoming more and more burdensome. Worldwide, the incidence of banking crises since the early 1980s is unprecedented. During 1980–96, 90% of IMF member countries from Africa, Asia or the transition economies had at least one serious banking crisis (Goldstein, 1997). In this context, governments are increasingly called upon to rescue banks, and expensive bail-out packages often substitute for the strict enforcement of prudential regulation. In Argentina, severe banking crises over two years cost 55% of that country's GDP (see Table 6).

Bailing out the banking sector is perceived as a priority because of the domino effects that a bankruptcy might provoke; the effects on small depositors and creditors; the effects on the manufacturing sector of a liquidity squeeze, and the potential loss of confidence of foreign investors, which may ripple out to other sectors of the economy.

Two aspects of liberalization have been cited as contributing to banking crises in developing countries — inadequate preparation for financial liberalization (in terms of strengthened banking standards and supervision) and the effects of large-scale capital inflows in creating a lending binge during the upswing of the business cycle (Goldstein, 1997).

Table 6. *Estimates of total losses/costs of severe banking crises (1980–96)*

Crisis	Estimated total losses/costs (percentage of GDP)
Argentina (1980–82)	55
Benin (1988–90)	17
Bulgaria (1990s)	14
Chile (1981–83)[a]	41
Côte d'Ivoire (1988–91)	25
Hungary (1995)	10
Israel (1977–83)[b]	30
Japan (1990s)[c]	10
Senegal (1988–91)	17
Spain (1977–85)	17
Venezuela (1994–95)	18

[a]Over 1982–85
[b]in 1983
[c]estimate of potential losses
Source: Goldstein (1997).

Apart from consequences on public budgets, financial crises and currency volatility raise distributional issues, which will be touched upon below, with the example of Southeast Asia.

4. DISTRIBUTIONAL IMPLICATIONS: THE EXAMPLE OF THE SOUTHEAST ASIAN CRISIS, 1997

In the summer of 1997, an export slowdown that had been building up in the newly industrialized economies of Southeast Asia degenerated into a large-scale currency crisis, which brought high rates of growth in the region to an abrupt halt, as their currencies were delinked from the dollar. Thailand, in particular, called the "epicenter of the earthquake", exemplifies the costs and benefits associated with international liberalization in trade and finance, and its consequences on public budgets, and ultimately, on people.

In May 1997, waves of speculative selling hit the baht, partly because investors started to regard the baht's peg to the dollar as unsustainable, as the dollar was soaring in exchange markets and as Thai current account deficits were widening. The baht was finally allowed to float on July 2, after the Central Bank had spent

billions of dollars in an attempt to maintain the peg, and was sent into freefall. On July 28, the Thai authorities agreed to an IMF-sponsored $16.7 billion rescue package to cover its foreign obligations. Roughly three-quarters of its foreign exchange holdings, or $23.4 billion, had been swallowed to resist devaluation or to shore up financial institutions. More than $19 billion, or close to 10% of GDP, were spent bailing out 91 finance companies that encountered trouble as a result of the crisis — the drop in property prices, the rise in interest rates. In May 1997, for example, the government had to take responsibility for Bangkok Bank of Commerce, a mid-size commercial bank, after it ran up bad debts of £2 billion. The oversized liabilities of the Thai Central Bank are a good example of the phenomena outlined above — the increasing burden of the state's role as lender of last resort, and the considerable amount of resources that are needed for a country to maintain currency stability in the face of massive and volatile capital flows.

In return for the exceptional line of credit extended by a consortium of countries and the International Monetary Fund (IMF), Thailand pledged a series of austerity measures, in particular, to slash £3 billion off its budget deficit in 198, and to generate $1.53 billion in budget surplus. High interest rates will be necessary to prevent inflation (which might result from the baht's depreciation), and to stop the baht's further slide. Growth is forecast to plunge to 1.9% in 1998, as opposed to 6–8% in the 1990s (in Mexico, the economy contracted by 6.2% in the year following the peso's devaluation). Obtaining a fiscal surplus with such a sharp drop in growth, and with a guarantee to depositors and creditors of failed financial institutions worth at least $7 billion, will require drastic cuts in public spending. Ending public service subsidies is already a component of the policy package. While the government has promised not to cut spending on health, education and social safety nets, even freezing spending at current levels would not be sufficient to meet the increased needs as unemployment takes its toll, and as more people require public assistance as a result of the crisis.

The second part of this story, the pressure on governments to smooth out the human costs of economic instability, further exemplifies the "spending" side of the fiscal squeeze. As the Thai example shows, governments are increasingly challenged as guarantors of institutions (such as the foreign exchange regime), and of social and economic stability in a sea of change.

Ironically, fixed or pegged exchange rates regimes are created to protect the real economy from short-run vagaries in the demand for currencies — yet, the "real" economy ends up paying the bill of financial volatility, via higher interest rates, fiscal losses associated with sterilization of bank bail-outs, and the belt-tightening that follows major currency crises. In the end, thus, public institutions are often called upon to absorb the costs of instability. These costs will also be borne by holders of baht-denominated assets (i.e. land, real estate, and shares in troubled banks), and by the poorer sections of society in the form of higher unemployment and a weakening of the social safety net.

Additional social costs derive from the devaluation-related inflation, which was beginning to be felt in August 1997, and was driven by the enhanced costs of imported food and fuel. Prices of food and beverages rose 9.5% year-on-year, with the price of rice and flour up 42% (*Financial Times*, 1997f, 2 September, p. 6).

True, the Thai monetary crisis was not solely due to globalization, or financial liberalization, but also in part to Thailand's reluctance to tighten credit earlier, for fear of suppressing growth, and to an underlying deterioration in competitiveness. Yet, adjusting to changes in competitiveness need not be so catastrophic. Surely, a smoother external adjustment mechanism could be devised. In addition, historical studies show that there is no firm way of predicting financial crises, however clear the policy mistakes are *ex post* (Eichengreen, 1996). If authorities, fearing a financial crisis, had resorted to monetary tightening as a preventative measure, the Thai economy could have been trapped in the low-growth dilemma described above resulting from high capital mobility, and that would also have had consequences on the public budget. Instead, "preventative cooling off" should be selectively applied — not to the economy as a whole (via higher interest rates), but to those flows or sectors that are most speculative and most subject to bubbles.

5. CONCLUSION

This paper has argued that, with globalization's advances, many countries are experiencing a "fiscal squeeze" in one form or another — increasing difficulties in raising revenue, and/or enhanced needs for public spending. The effects of liberalization are either direct or indirect, and may be summarized in Table 7.

Table 7. *Effects of liberalization on public budgets*

	Trade liberalization	Investment liberalization	Financial liberalization
Direct effects			
	Loss of revenue from tariffs	Challenges to tax collection	Loss of revenue from "financial repression" Additional spending to cope with volatility
Indirect effects			
	Need for additional resources for: — firms (subsidies) — societal adjustments (education, safety nets)	Tax competition	Lower inflation Financial crises

Source: Author.

The demonstration, however, is far from complete. The effects of globalization need to weighed against other sources of fiscal strain, such as demographic factors, cyclical factors, or deliberate policies to reduce taxes (mandated by the electorate or by policy conditionality). Empirically, the "squeeze" hypothesis may not easily be tested by broad, macroeconomic indicators, because these respond to a very wide variety of factors, including cyclical phenomena/ Indeed, deficits have recently improved in many parts of the world (Table 8). Yet, running a deficit is only one way of coping with a fiscal squeeze. Other possible adjustments are spending cuts or tax reform, often with consequences on equity or sustainable human development. In many cases, "squeeze" effects are already being corrected by policy adjustments such as privatization or "burden-shifting" to immobile factors (workers, consumers).

Instead of looking for broad-based, aggregate figures, the "squeeze hypothesis" could be tested by calculating, for specific countries, the cumulative effects on budgets induced by actual liberali-

Table 8. *Budget surplus or deficits as a percentage of GDP*

	1980	1995		1980	1995
Korea	−2.2	−0.2	Chile	5.4	1.6
Spain	−4.2	0.0	Malaysia	−6.0	0.8
New Zealand	−6.7	0.1	Mauritius	−10.3	−1.4
Ireland	−12.5	−0.2	Turkey	−3.1	0.0
Israel	−15.6	−2.9	Panama	−5.5	4.3
United Kingdom	−4.6	0.1	Thailand	−4.9	1.8
Australia	−1.5	−0.5	Costa Rica	−7.4	−2.9
Italy	−10.7	−10.5	Peru	−2.4	0.0
Sweden	−8.1	−6.9	Paraguay	0.3	1.2
Netherlands	−4.6	−4.9	El Salvador	−5.7	0.0
Belgium	−8.2	−0.5	Romania	0.5	0.0
France	−0.1	−5.5	Syria	−9.7	−4.1
Singapore	2.1	0.0	Philippines	−1.4	−1.5
United States	−2.8	−2.3	Indonesia	−2.3	0.6
Denmark	−2.7	−2.0	Sri Lanka	−18.3	−0.1
Japan	−7.0	0.0	Cameroon	0.5	−1.7
Switzerland	−0.2	0.1	Senegal	0.9	0.0
Greece	−5.0	−15.7	Pakistan	−5.7	−4.8
South Africa	−2.3	−6.2	Zambia	−18.5	−2.9
Argentina	−2.6	0.0	Ghana	−4.2	−2.5
Uruguay	0.0	−2.8	Nicaragua	−7.2	−4.3
Oman	0.4	−11.2	India	−6.5	−5.4
Chile	5.4	1.6	Kenya	−4.5	−3.2

Source: World Bank (1996) (World Bank, various).

zation measures, and balancing these effects against estimates of additional revenue brought about by liberalization — direct effects, of course, will be easier to evaluate than indirect effects, whether positive or negative.

Indeed, openness may, in turn, have beneficial effects on public budgets, simply because it creates wealth and therefore enlarges the tax base per capita, and provides livelihoods for many who would otherwise rely on public assistance. This "benign" consequence of globalization on budgets, however, depends on the reality of a growth phenomenon, and of a "trickle down" effect. If wealth does not trickle down to the poorer segments of society simply via the operation of the private sector, the public sector will be called upon to correct the rising inequality. Yet, in doing so, it will be increasingly constrained by the phenomena we have outlined above — challenges to tax revenue, the growth of the informal economy, and the competitive pressures from low-regulation and low-tax areas. In addition, in the less progressive tax environment that seems to be taking shape worldwide, growth that does not trickle down will easily feed into public revenue.

If the squeeze hypothesis is indeed demonstrated, it could exemplify the mounting challenges encountered by the public sector, which is still largely fragmented into states at a time when the market is increasingly global. The trend toward decentralization further accelerates this fragmentation, and the policy competition and rivalries it entails. The discrepancy between a global private sector and a fragmented public sector makes the latter increasingly inefficient in fulfilling its traditional mandates — providing public goods, guaranteeing social stability, providing a framework for the exercise of democracy. The fiscal squeeze, whether it turns out to be a general phenomenon or an anecdotal one, is an example of this predicament.

This leaves open a vast need for policy responses, which must be actively researched, tested and elaborated. In many cases, the loss of corporate tax revenue can be made up by consumption, pollution or property taxes, which can be designed to be progressive. Policy competition may be handled by enhanced coordination — Vito Tanzi, of the IMF, has recently proposed the creation of a World Tax Organization (Tanzi, 1996). Similar ideas are being developed in the European Union context. Coping with large capital inflows can be made revenue-generating, rather than revenue-costly, with deposit requirements for foreign investors, or taxes on short-term inflows (Ffrench-Davis and Agosin, 1996). Other responses could tap into the private or non-profit sector's potential for fulfilling quasi-public functions. Making the best of globalization opens up a large agenda for policy innovation.

NOTES

1. Shome, 1995, p. 61; public deficit figure from IMF, (1996a, b).

2. This issue was discussed at the Symposium on "The Multi-jurisdictional Taxation of Electronic Commerce", Harvard University, 5 April 1997, organized by the International Tax Program and the Society for Law and Tax Policy, Harvard Law School.

3. For the problem of effecting a transition to a "taxed economy", see Tanzi (1992).

4. Common investor complaints in Malaysia cite "regular electricity black-outs, the rising cost of water, and road toll fees" (*Financial Times*, 1997d, 20 August, p. 5).

5. *Financial World* (1995, 20 June, p. 6), quoting estimates from the Cato Institute.

6. Quoted in IMF (1996c).

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