Globalization, Public Finance and Poverty

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In this research note, we emphasize the impact of “globalization” on the poor through public finances. Considerable research suggests that global trade or finance has led to a reduction in corporate tax rates and takes (Cao 2010), a concomitant increase in consumption taxes, (Beramendi and Rueda 2007), and reductions in welfare spending (Huber and Stephens 2001). Though the findings might vary across the developed and developing worlds, the basic idea is that global economic forces are bad for the poor to the extent they constrain the progressivity of taxation and/or public spending.

We argue that there are two profound limitations on what we know: First, the reliance on standard cross-national public finance sources has elided broad budget categories with the actual incidence of taxing and spending across the income distribution; and second, almost no research has considered tax expenditures, which represent a black box in our knowledge of public finances and seem to limit fiscal effort in favor of the poor. In the following pages, we discuss these issues sequentially. We conclude with some recommendations for future work that would provide a more solid evidentiary for work on the political economy of public finances.

1. *Globalization and the Incidence of Taxing and Spending*

If globalization impacts poverty or inequality through fiscal policy, much hinges on the ability of budgetary data to proxy the redistributive incidence of taxes and transfers. The redistributive incidence of public policy is an old problem in public economics, where it is well established that the size of particular budget categories is a very poor proxy for their distributive impact. The implication is clear: trying to make sense of the socio-economic consequences of globalization on the poor by focusing on the budgetary size of policies allegedly benefitting the poor (such as social spending) is a fruitless and potentially misleading path.

To see why, consider the standard decomposition of the redistributive impact of fiscal policy. Following Kakwani, the overall redistributive impact of the fiscal system – measured by the difference between market and disposable income Gini coefficients – can be broken into two components (Kakwani 1977): The scope of the effort and its progressivity. The relationship can be formally stated as follows:[[1]](#footnote-1)

[1]

where *t* denotes the tax level, *b* denotes the benefit level and βT and βB indicate the progressivity of taxes and benefits. That is to say: the redistributive incidence of public finance is a function of both budgetary effort and design, i.e. of the size of the welfare state (t) and the progressivity of its taxes and benefits (βT, βB). Obviously, the same tax, an income tax for instance, can be more or less progressive. The same holds for expenditures; spending on social security, unemployment, education and the like vary not only in scale but also in progressivity across countries.

Any claim on the effect of globalization on poverty via public finances would have to take the incidence of taxes and spending seriously, but most research has not. Most cross-national work on the link between globalization and public finances relies on the IMF’s *Government Finance Statistics* (GFS), which provides no information on incidence. The GFS reports revenues under 4 broad categories and expenditures under 10 broad categories; these broad categories are in turn broken into a plethora of subcategories. There are important benefits to the GFS. Most importantly, it provides the best-harmonized and documented set of fiscal data for the largest number of countries over the largest number of years.[[2]](#footnote-2) Some serious limitations in hand, particularly those bearing on non-random missingness in country coverage and difficulties comparing across versions, the GFS is an important tool for cross-national work public finance.

More problematic than the data itself is the way researchers often unreflectively assume that IMF budget categories can be identified as pro-poor or not. In much research, for instance, “Social Security and Welfare” and “Education” spending, are defined as pro-poor, and consumption taxes are assumed to be regressive. To the extent exposure to different types of global markets is correlated with a rise or decline in these budget categories, researchers make claims on the implications for poverty, inequality and other distributive concepts. We are wary of most of the conclusions drawn from such work because it fails to consider the incidence of taxing and spending.

Figure 1: “Social Spending, Fiscal Redistribution, and Poverty”



Figure 1 provides some insight into the importance of considering the incidence of taxing and spending policies. In the left panel we plot the level of social spending for all available years in 1990-2010 (x axis)[[3]](#footnote-3) against a measure of the state’s redistributive incidence of all taxes and transfers (left-panel)[[4]](#footnote-4); in the right panel, we consider the relationship between social spending and the percentage of people below the national poverty line.[[5]](#footnote-5) This gives a more direct picture of the connection between budgetary effort and the fortunes of the poor.

Figure 1 reveals three things. First, there is a correlation between the size of spending effort, reductions in inequality, and poverty. This captures the fact that budgetary effort is a necessary condition for redistribution towards the poor to take place. Second, the correlation is far from perfect: at both low and high levels of social spending, there is considerable cross-national spread in redistributive incidence (reflecting differences in the progressivity of the design of taxes and transfers) as well as in poverty. Third, the spread seems larger as the scope of the effort increases. While Norway and Spain spend about the same amount, for instance, that spending does twice as much to reduce inequality in Norway as it does in Spain. Differences in design matter more as the size of the budget grows. Thus, Figure 1 highlights the importance of two issues for cross-national research on the relationship between globalization and the poor: progressivity and fiscal capacity.

Regarding progressivity, Figures 2 and 3 below provide additional, more precise, evidence that social spending varies in its incidence. Since GFS does not provide data on incidence, we have relied on the Luxembourg Income Studies (LIS), which provide high quality, harmonized data on the basis of a common set of income surveys. Though the LIS is widely recognized as the highest quality, cross-national income survey, it has only recently begun to sample beyond the OECD. As a result, it has very weak coverage across the developing world. The data presented below is from income surveys conducted in the mid-2000s.

Figure 2:

*The Distribution of Social Transfers by Income Decile*

Figure 2 shows how social transfers are distributed across the income distribution for a set of middle- and upper middle-income countries in Latin America and Asia. We also include data for Sweden, the social democratic ideal, as a point of comparison. Figure 2 shows the share of total social transfers by income decile. When reading this figure it is important to keep in mind that Korea and Taiwan spend much less on social insurance, both as a share of their total budgets and as a share of GDP, than the other cases. That in mind, the figure shows that Sweden spends about 60 percent of its social insurance on the poorest half of the population, and spending falls as the population gets richer. When researchers code the GFS’s “social security and welfare” spending category as pro-poor, this is what they have in mind. Alas, the other countries spend their social budgets in much more regressive ways. While the share spent on each decile climbs slowly in Korea, Taiwan’s spending is “U” shaped, showing that it is concentrated at the low and very high end of the income distribution. There the richest decile receives about 60 percent more of total social transfers than the poorest decile, which is directly connected to generous pensions for high-earning positions in a very competitive public sector. The four Latin American cases display even more regressive profiles. In Brazil, Colombia, Mexico and Uruguay, the poor receive small shares of total social transfers. The shares slowly climb across the income distribution until they spike in the top decile. In Brazil, for instance, the top decile receives ***38 times*** the share of transfer income as the poorest decile. This latter finding is particularly striking because the data includes Brazil’s large conditional cash transfer program, Bolsa Familia, which is targeted at the poor and has done much to alleviate poverty. The overall regressive incidence of social transfers emerges from the simple fact that the social security system in Brazil is huge and hugely maldistributive.

Figure 3:

Social Transfers as a Share of Market Income by Income Decile

Figure 3 brings budgetary size back into the analysis by reporting transfer income as a share of market income by income decile for the same set of cases. Again, the Swedish case stands out as the most progressive. For individuals in the poorest decile, social transfers are nearly three times their market income; for individuals in the top decile, social transfers are a tiny share of their market income. The Korean and Taiwanese cases evince the same downward sloping curve, but because they spend so much less on transfers, they make up a much smaller share of the poor’s income. Again, the Latin American cases evince distinctively regressive social effort. In all four cases, the curves are basically flat, which indicates that social transfers make up about the same share of income for the rich as they do for the poor. Given that the rich have considerably higher market incomes than the poor, this implies that most transfer spending is actually being targeted at the rich, which is exactly what we saw above in Figure 1a.

Overall, our analysis suggests that the GFS’ broad budget categories do not provide the foundation for generalizing about the impact of globalization on the progressivity or regressivity of public finances. It is incorrect, for instance, to suggest that any globalization-induced reduction in the GFS’s “social security and welfare” spending would be bad for the poor. Indeed, in a country like Brazil a reduction in the size of the social security system would almost certainly be good for the poor. Rather than making untenable assumptions about the distributive implications of broad budget categories in GFS, research should consider the actual incidence of taxes and transfers.

*2. Fiscal Capacity and Tax Expenditures*

A second major issue concerns the state’s ability to deal with globalization. Figure 4 shows the relationship between the strength of the tax bureaucracy[[6]](#footnote-6) and the amount of revenue generated (left panel)[[7]](#footnote-7) and between the latter and the redistributive incidence on non-pension social transfers.

Figure 4: “Fiscal Capacity and Incidence”



Countries with legacies of low state capacity, such as India or Peru, cannot generate significant resources to redistribute via pro-poor policies simply because they have such weak fiscal capacity. Under those conditions, any impact of globalization on the poor via public finances is likely to be quite marginal since fiscal capacity is so anemic. At the other end, in rich, open economies, globalization is unlikely to reduce the redistributive scope of the state. Many of these societies developed redistributive welfare states and trade-oriented growth strategies concurrently, so exposure to external competition does not come as a shock to prior distributive equilibria. More interesting is the case of countries with intermediate levels of capacity (Spain, Greece) and revenues (the USA). In these cases, much of the redistribution takes the form of tax expenditures.

Tax expenditures are abatements; they are taxes that the government agrees to *not* collect. Imagine that a government wants to build a $10 million bridge. It can collect the revenues, budget the bridge as a capital expenditure, and contract with a firm to construct it. Alternatively, the government can avoid the budgetary process entirely by “paying” the contractor with a $10 million tax credit. Holding the tax treatment of revenue and deferred taxation constant, the contractor is indifferent between these two mechanisms. The government might prefer the tax expenditure to the public budgeting since it is subject to less negotiation, transparency and oversight, even if the sums involved are the same. Citizens, of course, might be concerned with the impact of the foregone revenues implied by the tax expenditure on the government’s capacity to spend on education, health and poverty relief.

One crucial difference between traditional budgeting and tax expenditures is that the latter are entirely invisible in traditional data on public finances. Indeed, there is no systematic data on tax expenditures beyond the OECD, and even there the data is spotty. This makes it difficult for analysts and citizens alike to assess the incidence of public finance. Indeed, available and necessarily superficial evidence suggests that among rich democracies, those who rely the most on tax expenditures are the ones with more unequal distributive outcomes. Table 1 presents some evidence on the basis of the 2009 OECD report on Tax Expenditures and the LIS Inequality and Poverty Database. The first column reports the size of income tax expenditures as a percentage of GDP; the second and third column, as a percentage of income tax and total tax revenues. Finally, the last column displays the share of population below 50% of the median disposable income.

*Table 1: Tax Expenditures and Poverty*

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **%GDP** | **%Income Tax** | **% Total Tax** | **Poverty (LIS, 50)** |
| **Canada 2004** | 5,8 | 59,4 | 44,4 | 12.97 |
| **Germany 2006** | 0,3 | 8,8 | 8,5 | 8.2 |
| **Korea 2006** | 1,8 | 24,7 | 14,3 | 13.96 |
| **Neatherlands 2006** | 1,1 | 9,9 | 5,1 | 5.2 |
| **Spain 2008** | 2,3 | 28,2 | 12,5 | 13.7 |
| **UK 2006** | 8,3 | 58,6 | 35,2 | 11.3 |
| **USA 2008** | 6,0 | 38,8 | 33,7 | 17.7 |

*Sources: OECD 2009; LIS Database*

The spotty picture in Table 1 suggests bad news for the poor in the developing world. Insofar as their governments have low fiscal capacity, large, regressive tax expenditures are likely to be attractive tools and pro-poor spending will be most limited precisely in the countries where it is most needed. Indeed, existing evidence suggests that tax expenditures are costing the world’s poorest a great deal.[[8]](#footnote-8) A recent report by Action Aid and Tax Justice Network-Africa (2012) implies that Uganda could double its health budgets with the revenues that are foregone by tax expenditures, and Rwanda’s lost revenues amount to 4.7 percent of GDP. Even in a higher fiscal capacity country like Turkey, tax expenditures have been reported at 5 percent of GDP (Swift 2006). In the absence of systematic data on tax expenditures, it is hard to be sure, but there is growing circumstantial evidence that much of these tax expenditures are associated with tax competition and an attempt to attract foreign direct investment (Keen and Mansour 2009).

*3. Conclusion*

Redistributive incidence reflects the fiscal capacity and the political taste for progressivity in a country. Focusing on one or the other in isolation leads to missing half the data generating process. Fiscal capacity is a necessary condition for pro-poor redistribution. In its absence, any impact globalization might have on the poor is unlikely to be mediated by the formal budget process, even if tax expenditures might play an important role in limiting the capacity of governments to collect revenues which could be targeted at the poor. For countries with greater fiscal capacity, there is a growing tension between any potential desire for progressivity and the need to compete for footloose capital. To the extent the latter results in reliance on regressive tax expenditures, globalization is likely to worsen the relative position of the poor.

Taking incidence seriously has important analytical implications for understanding political engagement by the poor (and the rich) in democracies. One byproduct of the failure to take incidence seriously is that a growing body of research is attempting to explain the supposedly anomalous taste of the rich in favor of redistribution and the poor’s resistance to it in some countries. Competing explanations abound: The poor are distracted by religious, ethnic or national attachments; they are divided along a deep urban/rural divide; the absence of unions and left parties to articulate the interests of the poor; or that the rich rationally support redistribution in light of its positive externalities for social peace. Yet none of this work takes the incidence of redistribution seriously and fails to recognize the prospect for regressive taxing and expenditure policies. Rather than complicated multidimensional politics, it could simply be that that the rich and poor understand when fiscal policies benefit them and when they do not (Beramendi and Rehm 2014). In countries where fiscal policy is regressive, the poor will not support redistribution while the rich will. In short, once we take the incidence of taxing and spending seriously, there might not be a mystery at all.

The implications for future work are clear. We should replace broad and probably insupportable claims on the effect of globalization on pro-poor tax and expenditure policies with more careful analyses of the actual incidence of fiscal policy. The main challenge is that such analysis relies on comparable income surveys that successfully measure the impact of various taxing and spending policies across the income distribution. The LIS aside, the World Bank has done considerable work in this area. Alas, despite its recent ASPIRE project, the Bank has not been forthcoming with its large collection of harmonized income surveys.[[9]](#footnote-9) While awaiting the gradual expansion of the LIS, researchers could put pressure on the World Bank to make its existing income surveys public. In a world where fiscal policy has become a crucial tool for managing the challenges posed by globalizing economic forces, it is crucial that we get serious about understanding how fiscal systems weigh upon the poor.

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1. See (Kakwani 1977, equation 3.2). [↑](#footnote-ref-1)
2. See IMF (2014) for 436 pages of technical details on GFS reporting standards and how budget categories are coded and harmonized across countries and years. [↑](#footnote-ref-2)
3. Data on social spending combine a variety of sources (OECD, GFS, ECLAC). While there is some accounting noise, for those cases/years in which we have observations for more than one source, the gap between the series tends to be relatively small (Sources: Beramendi, Pablo and Melissa Rogers, Geography and Capacity, WP Duke University and Claremont University). [↑](#footnote-ref-3)
4. Redistributive incidence is defined as the proportional reduction in the levels of market inequality associated with the policy under consideration. See Solt (2009) for a description of data and sources. [↑](#footnote-ref-4)
5. When possible we use comparable data from LIS data (Wave VIII or latest), setting the poverty line at 50% of the national median of equivalized household disposable income. In the absence of LIS data we rely on the World Bank Inequality and Poverty database, where national poverty lines may vary. This caveat applies to the following observations: Chile, Ecuador, Indonesia, Panama, Philippines, Tanzania, and Thailand. [↑](#footnote-ref-5)
6. Source: USAID Project on Fiscal Reform. The indicator captures the number of tax agency personnel per 1000 inhabitants in each country. [↑](#footnote-ref-6)
7. Same sources as social spending above (see fn. 4) [↑](#footnote-ref-7)
8. See Fuest an Riedel (2009) for a review of the relevant literature. [↑](#footnote-ref-8)
9. See the ASPIRE project: <http://datatopics.worldbank.org/aspire/>. It represents an attempt to provide micro-evidence on distributive effort across more than 80 countries. [↑](#footnote-ref-9)