

# Why we need public spending

by

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October 2010



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## Executive summary

- The steady rise of public spending for the past 150 years, in all countries, demonstrates a powerful link between public spending and economic and social development. Spending is now at historically high levels of 40% of gross domestic product (GDP) in OECD countries, and rising in developing countries.
- Public spending is a key factor in economic growth and development. It is essential for financing infrastructure, including roads, electricity, and water. It provides the health and education services necessary for modern economies more efficiently and effectively than the market could provide.
- Public spending has been used worldwide to provide an economic stimulus to counter the recession, and to rescue the banks through public ownership. The crisis was not caused by government deficits, but it is being managed through public spending.
- About half of all the jobs in the world are supported by public spending; two-thirds of them in the private sector through contracts and multiplier effects. Through 'fair wages' clauses and employment guarantee schemes it can spread decent work to many people beyond the public sector itself. Most sectors of the economy are now connected to public spending through subsidies, contracts and investment finance.
- By redistributing money to those on low incomes, it redresses the inequality of income created by the market, and increases spending power. Public healthcare, housing and other services protect people from illness and develop cities without slums. Three-quarters of the global effort to counter climate change will come from public finance.
- Globally, public spending is virtually certain to continue rising sharply, as the role of the state continues to grow in developing countries.
- 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.
- Privatisation and public-private partnerships (PPPs) are illusory ways of raising money, which conceal public borrowing to evade fiscal limits set by the International Monetary Fund (IMF) or the European Union. They are more expensive than direct government borrowing. PPPs suck up public spending for decades, and make government budgets much less flexible in future.
- 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.

## 0. Introduction

This report is written at a time of great conflicts over public finance.

Faced with the financial crisis and a global economic recession, governments have rediscovered the power of public finance. They used it to rescue the bankrupt banks, and to create more economic activity to hold back the worst forces of recession. Tens of millions of workers are in jobs today who would be unemployed without that economic boost from public spending.

But now there is a conservative backlash demanding that the deficits used to create the stimulus must be cut back by cutting public spending on a grand scale. The backlash comes not only from conservative governments, but from international institutions, led by the International Monetary Fund (IMF), which are insisting that public services are now 'unaffordable', and that healthcare and pensions in particular should be dependent on the market.

This report aims to demonstrate that these arguments and policies are wrong, not just in the short term but in the long term. For the past 150 years public spending has been driving economic growth and development, and rising steadily in all countries of the world. Far from being a burden on economies, it is an essential driving force, providing universal services for human development – healthcare, education, social security – and also the essential infrastructure making other economic activity possible, such as water, electricity, roads. If there is to be future growth and development, we should expect public spending to continue to grow, not to be cut back.

In particular, there are two major reasons why public spending needs to grow, not fall back. One is the need for essential infrastructure in the global south – for human and economic development – which will require large investments over many years and the creation of lasting universal public education and health services. The other is the massive effort to combat climate change, which is overwhelmingly dependent on public finance.

The affordability of this activity is a political issue. It will require higher contributions but more fairly distributed. Most tax systems in the world make the poor pay the same proportion in tax as the rich, because of an emphasis on regressive indirect taxes. Corporations have been taking a larger share of the economy in profits, while paying less and less in taxation, through tax havens and other forms of evasion. Financial companies pay almost no taxes on the transactions that generate their profits, though they have accepted billions of dollars of public money in the bailouts.

Deficits have arisen because of the crisis, not the other way around. Deficits are necessary to deal with the crisis. They will be reduced through rising revenues by growth, employment and fairer taxation policies, as they have in the past. The illusory, wasteful and dangerous use of public-private partnerships (PPPs) to conceal borrowing should be ended in favour of honest accounting.

The demands of the IMF and conservative governments would be damaging for employment, development and the environment. This report is intended to help resist those policies.

This report was commissioned by Public Services International (PSI). It draws on research carried out for PSI, the European Public Services Union (EPSU) and others over the last 12 years; on work with many trade unionists, civil society groups and researchers around the world; and on teaching and research at the University of Greenwich.

## Section I: The economic benefits of public spending

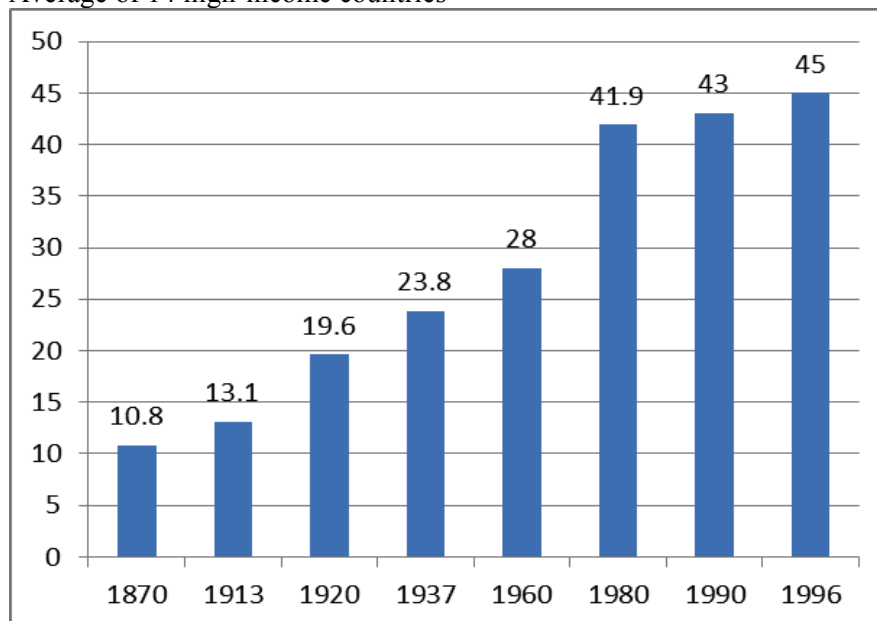
### 1. The long-term link between growth in public finance and economic growth

Public spending is often discussed as though it was a burden on a market economy, which would grow much faster if only public spending were cut back. But the economic history of the last 150 years shows exactly the opposite: that economic growth has gone hand in hand with a rising proportion of public expenditure since the mid-19th century. Taxation and spending in high-income countries as a proportion of gross domestic product (GDP) peaked during the two world wars of the 20th century, but the level of state spending and taxation remained high and continued to rise again after World War II until the 1990s.

This is not just true of European 'social democrat' countries; the same inexorable growth can be seen in the USA and Japan. And the same pattern can be observed in each individual country, not just overall. The pattern does not just show public spending rising in line with GDP; it shows public spending rises *as a proportion of GDP*.

**Chart A. Government spending as % of GDP 1870-1996**

Average of 14 high-income countries

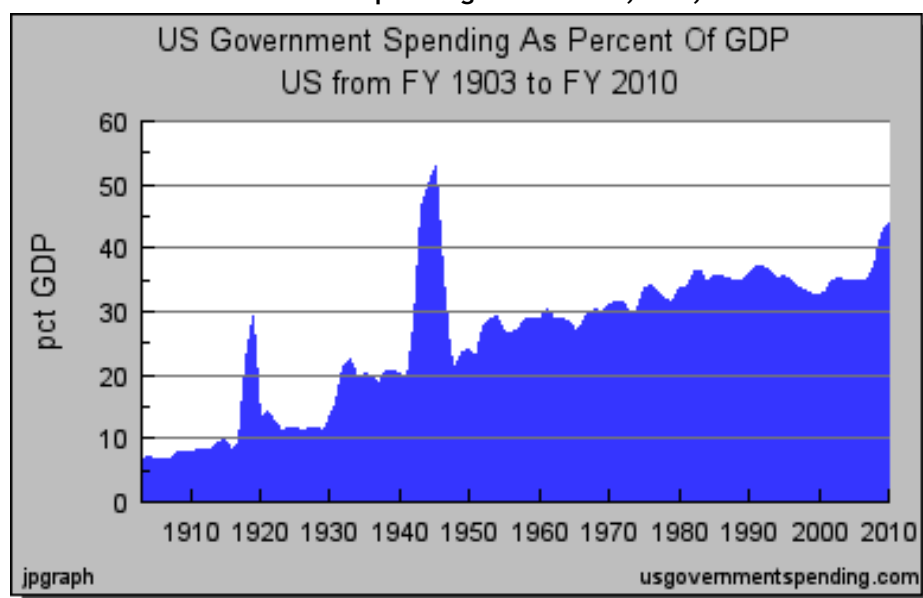


Source: Tanzi and Schuknecht 2000<sup>1</sup>

**Table 1. Government spending as % of GDP, 1870-1995: by country**

Table 1: Total Government Spending Relative to the Size of the Economy (Percent GDP)

	1870	1880	1890	1900	1910	1920	1930	1938	1950	1960	1970	1980	1990	1995
Australia	--	--	--	--	--	--	--	--	23.9	22.8	26.1	33.2	37.1	37.3
Austria	11.4	11.7	12.9	15.0	17.6	14.7	19.8	15.2	25.1	30.4	35.3	47.2	48.2	51.5
Belgium	--	--	--	--	--	--	--	21.8	23.7	30.7	37.5	51.7	54.7	54.6
Canada	6.2	7.0	7.8	8.7	11.3	19.0	18.9	21.6	21.9	29.1	35.8	40.6	46.5	48.1
Denmark	9.2	8.9	10.6	10.8	12.3	15.4	13.5	16.7	19.6	25.2	39.4	55.6	58.1	61.6
Finland	--	--	--	--	--	--	--	--	25.8	26.9	30.5	37.0	42.5	59.1
France	11.0	14.6	14.3	14.5	15.1	22.4	29.4	29.4	29.3	34.0	37.7	43.3	49.6	54.1
Germany	9.5	9.9	12.9	14.2	16.0	25.0	29.4	36.9	29.2	32.2	36.9	46.5	44.9	47.7
Ireland	--	--	--	--	--	--	20.8	32.9	30.3	27.3	37.9	52.3	42.4	40.3
Italy	14.4	13.7	18.4	16.3	17.3	30.2	22.0	29.2	23.0	29.7	31.7	44.9	51.6	51.8
Japan	8.8	9.5	12.0	17.5	24.3	19.2	26.8	29.9	15.9	17.8	18.6	32.3	31.3	36.1
Netherlands	9.1	--	--	--	9.0	13.5	14.0	23.2	27.1	34.6	42.3	56.5	54.0	54.2
Norway	5.9	6.8	7.4	9.9	9.3	12.8	19.1	20.3	24.2	31.3	41.3	48.8	54.8	49.0
Portugal	--	--	--	--	--	--	--	--	16.4	17.8	22.0	38.0	42.8	45.3
Spain	--	--	--	--	8.3	9.3	--	18.4	--	17.7	21.5	31.1	42.0	46.6
Sweden	5.7	--	--	--	10.4	12.8	19.1	20.3	26.3	31.3	42.8	60.9	61.5	67.0
Switzerland	--	15.8	14.3	10.6	14.0	17.0	17.4	23.9	20.8	21.0	26.7	35.0	33.4	38.4
United Kingdom	8.7	9.1	9.2	14.9	12.7	27.4	24.7	28.6	32.0	32.1	37.8	44.3	40.4	44.2
United States	8.3	5.9	6.5	7.9	8.2	9.4	12.2	19.7	22.4	28.4	33.7	35.3	36.8	36.1

Source: Cusack and Fuchs 2002 <sup>2</sup>**Chart B. Government spending as % of GDP, USA, 1903-2010**Source: [http://www.usgovernmentspending.com/us\\_20th\\_century\\_chart.html](http://www.usgovernmentspending.com/us_20th_century_chart.html)

This is not just a coincidence. There is a statistically significant link between rising levels of public spending and economic growth, in developing countries as well as high-income countries. This 'long-run' link is known as 'Wagner's Law' after the economist who first identified it in the 1880s, and has been repeatedly confirmed by the great majority of studies since then. Recent reports include:

- An analysis of 23 high-income countries from 1970–2006 by two central bank economists confirmed “a positive correlation between public spending and per-capita GDP ... [and] a common development among the 23 countries and the widespread validity of the Wagner's law”. <sup>3</sup>
- A study of 51 developing economies by staff at the International Monetary Fund (IMF) found that there was a consistent link across all countries, confirming “a long-term relationship between government spending and output consistent with Wagner's law”. An analysis of India from 1950 to



2008 also confirmed “the validity of Wagner’s law in India ... there exists a long-run relationship between economic growth and growth in public expenditure”.<sup>4</sup>

So growth in public spending is not a handicap to economic growth, but seems to be an essential part of economic growth and development, in all countries. Explanations for this link identify a range of ways in which a rising proportion of public spending helps economies:

- Public spending has a crucial role in investment in infrastructure. There are benefits to the whole economy from having good roads, railways, electricity and water supplies, but it is not profitable for private investors to build them. In all countries, infrastructure investment has been driven by the public sector: most of the productivity gains in the ‘golden age’ of the USA’s economy were due to public investment in infrastructure including roads and electricity.<sup>5</sup>
- Public spending is a more efficient way of producing many services. A recent study on health and education spending in OECD countries found that “public expenditures affect GDP growth more than private expenditures.” This is consistent with the strong evidence that public spending on healthcare is much more efficient, in economic terms, and more effective, in terms of health objectives, than private spending on healthcare (see below). Very simply, public healthcare is more efficient for the economy as a whole.<sup>6</sup>
- A healthy, well-educated workforce is more productive: “... human capital theory suggests that when oriented towards health and education, such redistributive programs contribute as well to the quality of the labor force, and hence the growth potential of the economy.”<sup>7</sup>
- Re-distribution of income increases consumer demand. This is because poorer people spend a much higher proportion of their income, and so redistributing income from rich to poor, through a benefits system stimulates economic growth: “State-sponsored redistribution policies thus may accelerate the pace of economic activity to the extent that they place additional income in the hands of families with relatively high marginal propensities to consume”.<sup>8</sup>
- Public services are an efficient collective long-term insurance mechanism. In industrialised economies, a public system of collective support in sickness, unemployment, old age etc., replaces the role of the extended family in agricultural societies. Provision of public services and social security allows people to spend more instead of using savings to protect themselves.
- There is a general benefit to social and economic stability: “The possible patterns of economic evolution consistent with the no-welfare-state option include chaos, stagnation, and the development of new and perhaps unprecedented economic systems”.<sup>9</sup>

The rise in public spending appears to have levelled off in many countries from the 1980s and 1990s. Some analysts argue that this is because the economic advantage of public spending has come to an end in rich countries, because the burden of tax acts as an economic brake and offsets the benefits of public spending.

But in most high-income countries the overall trend is once again moving upwards. This revived upward movement has accelerated even further since the crisis of 2008, so that the growth is back to its long-term trend. The economic crisis and the policy responses have had a large effect on public spending, especially in OECD countries. In all countries, public spending leapt by 3% to 4% of GDP in one year. The average level across all 27 EU countries in 2009 was over 50%, for the first time, and in the USA and Japan it was above 40%, also for the first time.

Moreover, the same pattern of ‘levelling off’ can be seen in developing and transition countries. In India, for example, the introduction of neoliberal policies in the 1990s halted the growth in public spending, until the election of a social democrat government in 2004 resulted in renewed growth in public spending.

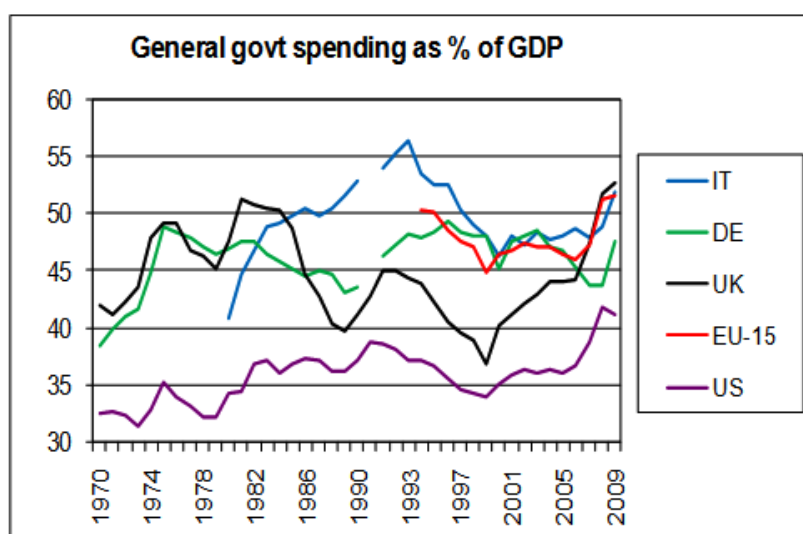
A better explanation for the levelling off is that trends in public spending depend on political decisions. There are real economic and social benefits of public spending, but the decisions on the levels are always the outcome of political processes: there is no market mechanism that automatically generates larger public



sectors. So the creation of welfare states and the development of public services was strongly associated with the rise of social democrat governments in Europe, and in newly independent developing countries. However, the spread of neo-liberal politics in the 1980s, led by the Thatcher, Reagan and Pinochet governments in the UK, USA and Chile respectively, achieved a temporary suppression of the trend in the north, and a more violent disruption of historical trends in transition and developing countries throughout the global south.

The long-term economic advantages of higher public spending remain unchanged. It is possible that one factor behind the economic crisis was the attempt to replace the economic engine of public spending with a financial bubble, which has now failed.

**Chart C. Government spending as a % of GDP in selected OECD countries since 1970**



Source: Eurostat; and PSIRU calculations

**Table 2. General government total expenditure as % of GDP, EU and other countries**

	CZ	DE	FR	IT	DK	UK	EU-27	USA	Japan
1970	n/a	38.5	n/a	n/a	42.2*	42	n/a	32.5	n/a
1980	n/a	46.9	45.7	40.8	52.7	47.6	n/a	34.2	n/a
1990	n/a	43.6	49.5	52.9	55.4	41.1	n/a	37.2	n/a
2000	41.8	45.1	51.6	46.2	53.6	36.8	44.8	33.9	39.0
2005	45.0	46.8	53.3	48.1	52.6	44.1	46.8	36.3	38.4
2006	43.8	45.3	52.7	48.7	51.5	44.0	46.3	36.0	36.2
2007	42.5	43.7	52.3	47.9	50.9	44.2	45.7	36.7	36.0
2008	42.9	43.7	52.8	48.9	51.9	47.4	46.9	38.8	37.3
2009	46.2	47.6	55.6	51.9	58.5	51.7	50.7	41.8	40.4

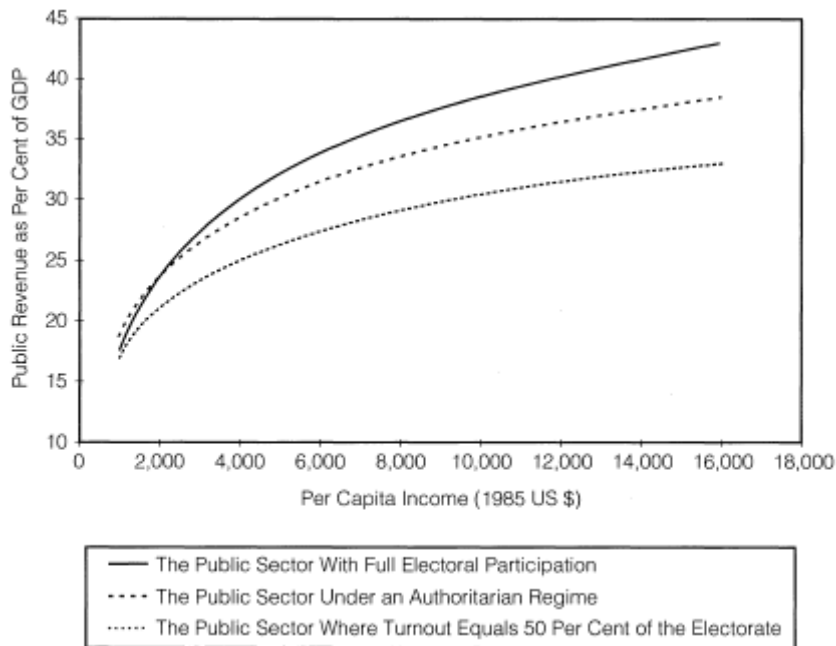
\*1971

Source: European Commission 2010<sup>10</sup>

There is also a clear link between democracy and public spending. Active democracies are more likely to produce higher levels of public spending than authoritarian regimes. Spain illustrates this point: while it was still under the dictatorship of Franco in 1974, government revenues amounted to 22.9% of GDP; ten years later, in 1984, the economy had not grown in real terms, but government revenues had risen to 32.7% of GDP. Participation also makes a difference: democracies with high electoral turnouts reach higher levels of public spending than democracies where turnout is 50% or less. Higher life expectancy also increases public

spending: the elderly need more public services and a greater incentive to vote for them. The set of curves in the following chart lay down a general framework for the relations between economic growth, public spending and democratic activity.<sup>11</sup>

**Chart D. Public spending, economic growth and democracy**



Source: Boix 2001<sup>12</sup>

## 2. Responding to the economic crisis

The financial crisis and the recession were not in any way caused by public spending, deficits or debts. But public finance has been crucial in government responses to the crisis. It has been used for two purposes:

- firstly, to bail out the banks and other financial institutions which would otherwise have collapsed;
- secondly, to provide an economic stimulus to counter the recession

These measures have been very effective in controlling the effects of recession. But they have necessarily had a big impact on the level of spending and the size of government deficits, especially in some European countries. Developing countries have not had to deal with bank failure, but have had to apply stimulus measures to counter recessions. The net effect has been an upward surge in public spending and deficits of about 4% of GDP, globally.

Most of this has been invested in infrastructure projects that provide long-term benefits.

### 2.1. Saving the banks

#### Box A. 'Nationalise to save the free market'

*Financial Times* 13th October 2008 FT leader 'Nationalise to save the free market'

"Does this rescue mean the end of private financial capitalism? Of course not. Nationally owned banks seem likely to be a reality in many countries for a decade. But stakes in banks will, eventually, be sold back to private investors. Governments – rightly – will regulate to avoid further crises. They will fail, and then be forced to act to pick up the pieces. There is no alternative. These leaders are not putting capitalism to the sword in favour of the gentler rule of the state. They are using the state to defeat the marketplace's most dangerous historic enemy: widespread depression. And they are right to do so."<sup>13</sup>

The financial and economic crisis was caused by unsustainable lending and the creation of complex forms of debt by banks. After one USA bank, Lehman Brothers, collapsed in September 2008, the USA and other governments decided to rescue banks by nationalising them, or injecting large amounts of capital to make them solvent again. This involved injecting capital by buying shares and providing government loans to banks, as well as general government guarantees on bank loans and deposits, and provision of greater liquidity. The IMF described this as "*an unparalleled transfer of risk from the private to the public sector*".<sup>14</sup>

The guarantees and liquidity measures, equal to 30% of the annual GDP of advanced economies, did not involve immediate government spending, but 'upfront' spending was made through injecting capital into banks, buying shares and extending government or central bank loans. This amounted to 5.5% of GDP of high-income countries – over USD \$1,800 billion dollars. As a proportion of GDP, it was greatest in the UK, which spent a sum equivalent to 20% of GDP on supporting the financial sector – equivalent to half the UK's annual spending on public services.

Some of the money spent may be recovered, e.g. by selling bank shares at some time in the future; and most of the guarantees will probably not be called upon. But the IMF expects that some elements of all this support will be permanently lost to governments – subsequent sale of the shares may not raise the full amount for which they were bought; some guarantees will be called on. It estimates that the total permanent loss will be 6.8% of GDP of advanced G20 countries – around USD \$2,700 billion.

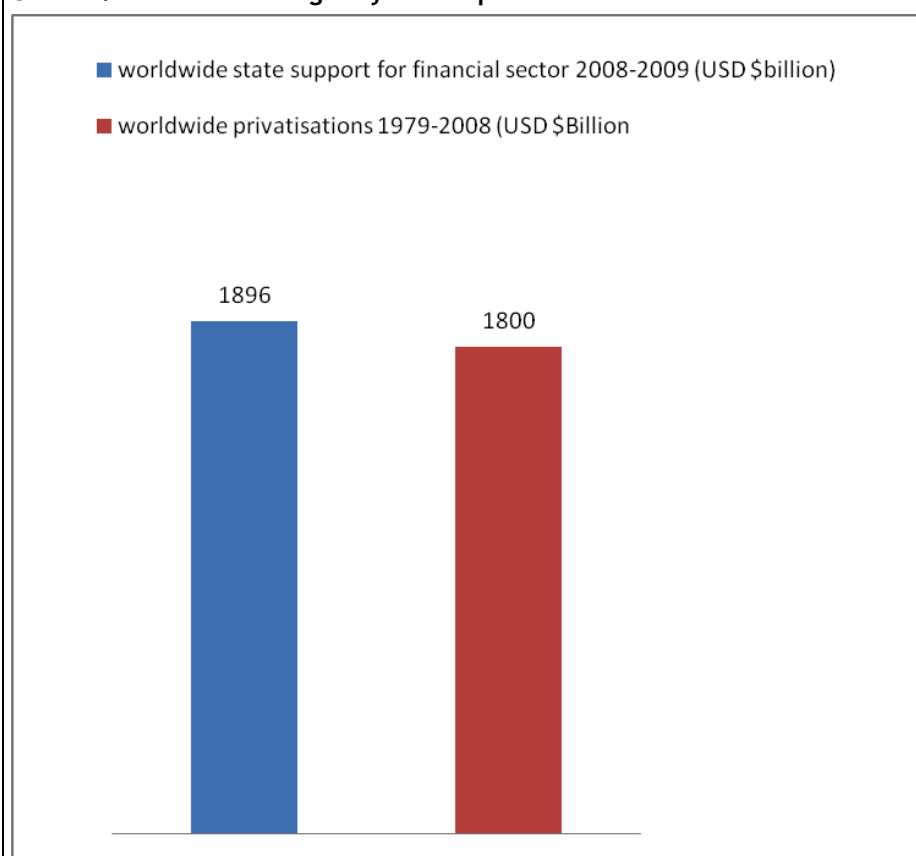
The cost of supporting the banks may rise further. In September 2010 the government of Ireland announced it was prepared to inject more money into a major bank: "the total cost to save its banks could rise as high as €50bn, more than a third of 2009 national income."<sup>15</sup>

**Table 3. Costs to governments of supporting financial sector**

	Total public sector support for banks etc.		... of which 'upfront' govt spending/borrowing	
	% of GDP	(USD \$bn)	% of GDP	(USD \$bn)
Advanced G20 economies	29.6	10246	5.5	1849
Emerging G20 economies	14.2	1672	0.4	47
Total G20	23.8	11918	3.6	1896
<i>Of which:</i>				
United Kingdom	81.8	1180	20.0	289
United States	25.8	3700	6.7	960

Source: IMF 2009 and PSIRU calculations<sup>16</sup>**Box B. Bank bailout bigger than all the privatisations in the world**

This upfront support to bail out the banks already totals about USD \$1,900 billion, without taking account of longer-term costs. This is equivalent to the total value of all the privatisations carried out worldwide in the last 30 years, which raised about USD \$1,800 billion.<sup>17</sup> In less than one year, the bailout of the financial sector has completely reversed this process. The public sector has injected more capital into the private sector in one year than the private sector has paid for state enterprises in the last 30 years.

**Chart E. Reversing 30 years of privatisation**Sources: see note.<sup>18</sup>**2.2. Saving capitalism: the economic stimulus**

To counter the recession, governments all over the world increased their deficits.

The biggest effect has not come from special additional government spending, but from the normal operation of taxation and public spending systems as ‘automatic stabilisers’. Government deficits automatically increase in recessions, because taxes fall and spending on benefits rises. Combined, this partially protects people from the fall in their incomes, and acts as an economic stimulus which partly offsets the effects of recession.

The IMF and others assume that unemployment benefits are the key part of government spending which increase automatically in a recession. But other public spending, especially on healthcare and the elderly, also rises in response to recession, and so “automatic stabilisation through all elements of social expenditure is about 3.5 times larger than the part coming from unemployment compensation alone.” Social spending as a whole absorbs about 16% of an economic shock, on average, and the protection is strongest where social spending is highest: in Sweden, about 43% of a shock is absorbed by social spending.<sup>19</sup>

This has two important implications. Firstly, the current attempts to cut public spending on the elderly and on healthcare risk undermining an important element in economic stability. Secondly, governments (and the EU and the IMF), which only take account of unemployment benefit, are not taking proper account of the automatic effect of recessions on this spending, and so the limits on government deficits are being applied too strictly. European Commission reports: “... downplay the automatic forces influencing the budget ... the neglect of the cyclical implications of pensions, health expenditure and disability pay, especially in evaluating alternative reform packages, could be storing up problems for the control of budgets in the future.”<sup>20</sup>

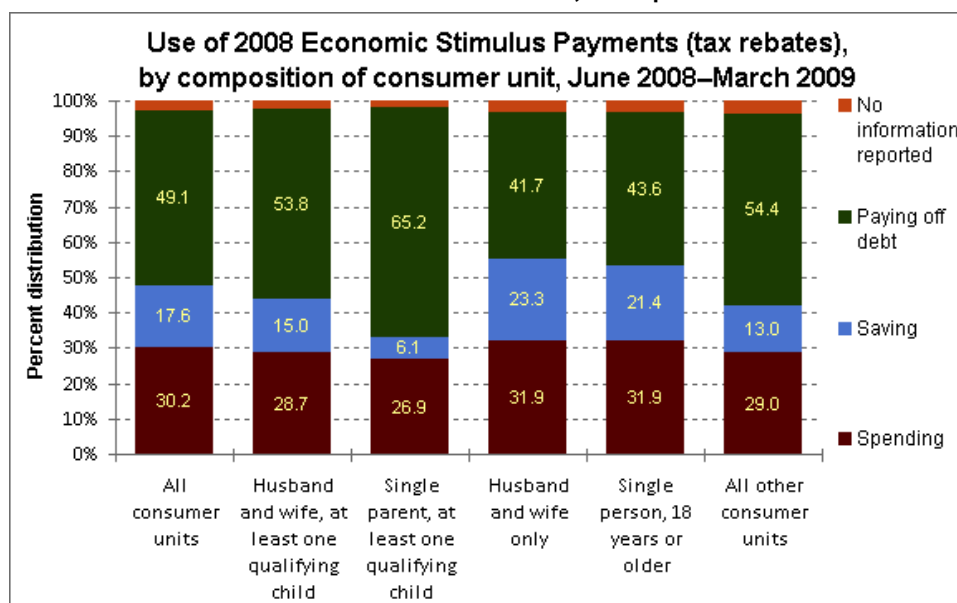
**Table 4. Economic stimulus as % of GDP: 2009**

	<b>Automatic stabilisers</b>	<b>Discretionary policies</b>	<b>Total stimulus</b>
All G-20 countries	1.9	2.0	3.9
<i>Of which:</i>			
Advanced countries	2.4	1.9	4.3
Emerging market countries	1.1	2.2	3.3

Source: IMF 2009B<sup>21 22</sup>

The stimulus packages contained a mixture of tax cuts and spending increases. The tax cuts reflect political preferences of the right, but, as data from the USA later demonstrated, tax cuts are a very poor way of stimulating demand in a recession, because people save rather than spend a large proportion. Only about 30% of the tax rebates given by the Bush government in May 2008 was actually spent: all types of households used two-thirds or more of the money to save or to repay debts.

Using the same amount of money to increase public spending has a much larger effect on demand and employment. For this reason, a large proportion of the stimulus packages consisted of increases in infrastructure spending. According to the World Bank in March 2009: “announced infrastructure spending for 2009 represents on average 64 percent of the total stimulus in emerging market economies and 22 percent of the total stimulus in high income economies”.<sup>23</sup>

**Table 5. Ineffective tax rebates: saved, not spent**

Source: USA Bureau of Labour Statistics. October 2009 'Pay off debt, spend, or save? The 2008 Economic Stimulus Payments' [http://www.bls.gov/opub/ted/2009/ted\\_20091023.htm](http://www.bls.gov/opub/ted/2009/ted_20091023.htm)

The crisis has done less damage to southern economies than it has to northern countries. Asian economies rebounded rapidly, led by China and India, which are now growing at around 10% per annum: Brazil is growing at a similar rate. Other countries in the south have also experienced less of a downturn, and are now (in 2010) expected to grow strongly.

Thus Africa did not even experience a contraction in 2009, when GDP growth overall was 2%. The IMF forecasts that in Africa there will be economic growth of 4.7% in 2010, and growth of 6% in 2011. This is partly due to the use of large fiscal stimulus packages: public spending plans in African countries were increased by 5% of GDP above the average level of the 2003–2007 period, including higher levels of spending on infrastructure, health and education. The IMF commented: “stimulus packages have been managed successfully without major impact on debt, and have increased the scale of public investment in infrastructure and the credibility of public spending on infrastructure”. The World Bank agrees: “The need to unwind stimulus measures among developing countries is generally less pressing [than in Europe]; because both fiscal deficits and debt-to-GDP ratios are much lower”.<sup>24</sup>

Some African governments are also confidently planning to finance their deficits by borrowing, including issuing bonds. Both Kenya and Tanzania plan to issue €500million bonds in Euros, Uganda plans a similar issue aimed at national rather than international investors. This policy is supported by a longer-term trend since 2000 for developing country governments being able to borrow money more cheaply, compared with rich countries. According to an IMF study, the spreads and effective interest rates paid by these governments has fallen in the last decade, so the cost of borrowing is lower.<sup>25</sup>

The OECD expects public spending as a percentage of GDP to increase across Africa as a whole until 2011, before falling back, but still to a level above that of 2008 (see table below). Because all international agencies forecast continuing GDP growth of over 4% per annum for Africa, the forecast still implies that actual public spending levels will be significantly higher – about 10% higher in 2011 than in 2008, in real terms.

**Table 6. Public spending as % of GDP in Africa, 2008–2011**

	2008	2009	2010	2011
Africa	30	32.8	33	31.6

Source: African Economic Outlook 2010<sup>26</sup>

**Box C. India: public spending for growth**

The government of India's budget for 2009–10, announced on 6th July 2009, included a strengthened stimulus to counter the recession, as well as longer-term growth of public spending as a platform for development. The budget increased the government deficit to 6.8% of GDP, to boost the economy; planned to raise more money from direct taxes; increased infrastructure investment and other public spending, including direct employment programmes; and committed to continued public ownership of banks and financial institutions. The government expected the budget to contribute to growth of 9% in 2010.

In 2008–09 the deficit had already risen from 2.7% to 6.2% of GDP, after the government introduced a package of spending increases and tax cuts to stimulate the economy. The government has promised to reduce this in the medium term but while "... uncertainties relating to the revival of the global economy remain ... we have to continue our efforts to provide further stimulus to the economy."<sup>27</sup> The government is confident it can borrow enough to finance this deficit: half of India's savings in the banking system "is channeled to the government through mandatory lending or through treasury bill sales".<sup>28</sup>

Central government revenue is now 11% of GDP, with over 50% coming from direct taxes, which is more progressive. The government plans to continue increasing the proportion of direct taxes, and refused to reduce corporate taxes. It is also continuing to improve tax administration, the importance of which was recognised by the finance minister: "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."<sup>29</sup>

The finance for urban infrastructure was increased by 87% over the previous budget, and a new fund was created, intended to make the country slum-free in five years. This not a short-term policy: the aim is to continually increase investment in infrastructure to reach more than 9% of GDP per year by 2014.<sup>30</sup> India is also using public finance to bail out existing public–private partnerships (PPPs) which are now unable to find private finance. A new public sector institution, the India Infrastructure Finance Company Limited (IIFCL), will refinance 60% of commercial bank loans to infrastructure PPPs over the next year and a half.<sup>31 32</sup>

India introduced a National Rural Employment Guarantee Scheme (NREGS) in 2006, which has provided employment opportunities for over 40 million households in 2008–09 and provided a significant boost to the rural economy. The minimum wage guaranteed under this scheme is being increased to 100 Rupees per day, and the overall budget is 8% higher than actual spending in 2008–09.<sup>33</sup>

The budget also included a strong long-term commitment to continued full public ownership of the banking sector: "Never before has Indira Gandhi's bold decision to nationalise our banking system exactly 40 years ago – on 14th of July, 1969 – appeared as wise and visionary as it has over the past few months ... public sector enterprises such as banks and insurance companies will remain in the public sector and will be given all support, including capital infusion, to grow and remain competitive." The government left open the possibility of future partial privatisations of other state-owned companies, however.<sup>34</sup>

**2.3. Rescuing the IMF**

The IMF itself has used the crisis to re-establish itself as an important international institution. By 2008 the international role of the IMF was much diminished. Many countries in Latin America and Asia had deliberately accelerated repayment of IMF loans in order to reduce their vulnerability to policy conditions that were seen as socially and economically damaging.<sup>35</sup> Asian countries have set up separate arrangements, known as the Chiang Mai initiative, to help avoid being forced to use the IMF. Indonesia, for example, can borrow \$28 billion from Japan to support its currency, and \$17 billion from China for trade finance.<sup>36</sup> A number of Latin American countries – Argentina, Venezuela, Bolivia, Brazil, Ecuador and possibly Paraguay – had previously agreed to create a 'Bank of the South', which is explicitly seen as an alternative to the World Bank and IMF in the context of south America.<sup>37</sup>

One effect of this was to cut the IMF's income from interest on its loans, so there was a risk of significant cuts. In 2008 it was agreed that the IMF could sell part of its gold reserves, and invest the proceeds to provide it with a secure income, which would support the institution regardless of whether it made any loans or not.<sup>38</sup>



The economic crisis was then used to justify a massive increase in the IMF's finances. The richest countries, meeting at the G20 in April, agreed to triple the resources of the IMF by extending 'New Arrangements to Borrow' (NAB) worth over USD \$500 billion – almost 1% of global GDP.<sup>39</sup> These are large amounts of public money: USD \$500billion is ten times as much as the USA government spent to buy General Motors.

The IMF is also borrowing money by issuing bonds, because China, India, Brazil, Russia and other 'emerging economies' would not give the IMF permanent extra resources until it is reformed and made more democratic. The IMF is not subject to stringent limits on these new borrowings. The justification for borrowing is extremely general: "Borrowing has been considered appropriate at times when the IMF's current or prospective liquidity was regarded as inadequate". The IMF board was explicitly asked, in July 2009, to agree that: "it would not be appropriate to establish a new limit on borrowing by the Fund in current circumstances". There is no limit on the amount it can borrow through issuing bonds. And the future 'exit route' for repaying all this debt is indefinitely postponed: "Consideration will need to be given in future to the policies governing repayment of borrowed resources. ... However, it is premature to consider the precise modalities of early repayments".<sup>40</sup>

**Table 7. The cost of supporting the IMF**

	<b>(USD \$bn)</b>	<b>% of GDP</b>
Advanced economies	<b>400</b>	<b>1.0</b>
Emerging economies	<b>100</b>	<b>0.9</b>

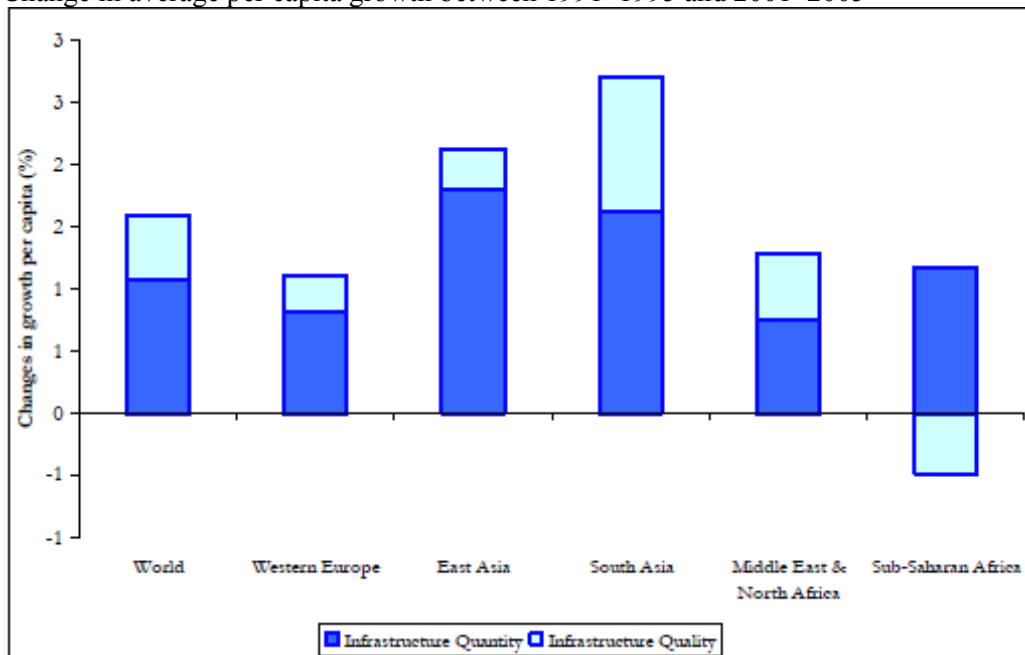
Source: IMF 2009 and PSIRU calculations<sup>41</sup>

### 3. Infrastructure

Investment in electricity, water and sanitation, roads, rail, and telecoms has played a major role in the growth of high-income countries, and is equally crucial in developing countries. Much of the economic growth and productivity of the USA in its ‘golden period’ in the mid-20th century was due to the growth in infrastructure, the great majority of which was publicly financed. The same effect can also be seen on every continent, including North America, Latin America, Europe, Africa and Asia.<sup>42</sup>

**Chart F. Change in growth due to infrastructure development**

Change in average per capita growth between 1991–1995 and 2001–2005



Source: Calderon and Servén 2008<sup>43</sup>

The importance of public investment in infrastructure was demonstrated by the damaging effects of the structural adjustment programmes of the IMF – which insisted on cutbacks in public spending – caused damaging falls in infrastructure investment in Latin America. At the same time the World Bank and IMF were requiring privatisation of key infrastructure services such as water and electricity, but the private sector failed to invest. As a result:

... in many countries the pressures of fiscal consolidation have led to a compression of public infrastructure spending, which has not been offset by the increase in private sector participation, thus resulting in an insufficient provision of infrastructure services with potentially major adverse effects on growth and inequality.<sup>44</sup>

In Latin America, government spending on human and physical infrastructure in the 1980s and 1990s, “dropped precipitously” during the period when the IMF imposed its structural adjustment policies, and led to a fall in economic growth: “... a major portion of the per-capita output gap that opened between Latin America and East Asia over the 1980s and 1990s can be traced to the slowdown in Latin America’s infrastructure accumulation in those years”.<sup>45</sup>

Most South American countries have now deliberately paid off their loans from the IMF, to enable them to pursue more rational economic policies, in which public spending on infrastructure has played a key role. In 2007 Brazil launched a four-year programme for economic growth, (the Programa de Aceleração do

Crescimento), based on the investment of USD \$236billion in roads, electricity, water, sanitation and housing. The programme is an explicit attempt to correct the previous under-investment: “In recent years, public investment has declined markedly ... capital investment has totalled less than 3% of GDP, well below the commitments being made by more rapidly growing countries in Asia.” This investment in infrastructure is seen as a crucial instrument for reducing regional and social inequalities.<sup>46</sup>

Public finance is central to these investments. In Brazil, this includes using tax revenues from central and regional governments, the operating surplus of state owned utilities, and national development funds, pension funds and savings funds. The sanitation investment programme, which aims for a great increase in the proportions of households connected to sewerage systems, is half financed by federal and regional state finance, and half by loan finance from the savings funds and pension funds. The “Luz para Todos” (Light for All) policy for connecting more people to electricity supply is overwhelmingly financed from federal and regional state funds, and is expected to have connected an extra 10 million people by 2010.

**Table 8. Financing electricity connections and water and sanitation, Brazil 2007-2011**

	USD \$billion
Federal government	8.6
Regional state and municipal budgets and operating surpluses	4.8
Workers’ savings fund (FGTS) and federal workers’ protection fund (FAT)	9.4
TOTAL	22.8

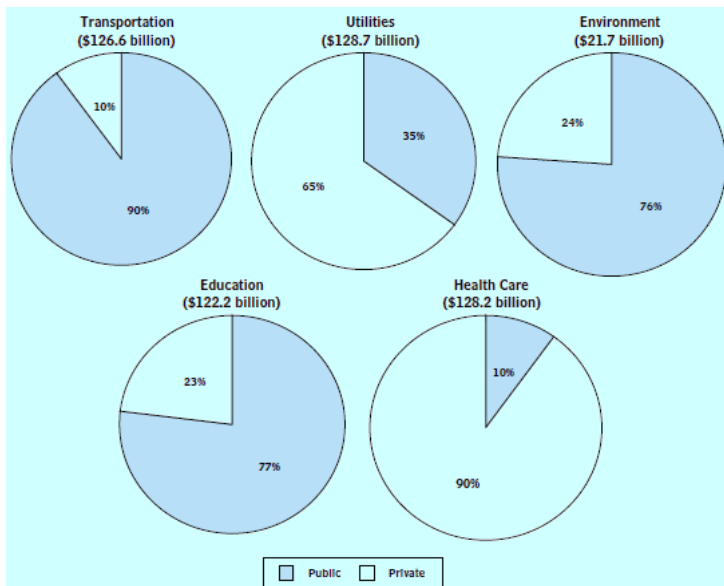
Source: see notes<sup>47</sup>

In Africa, by contrast, the level of infrastructure spending remains inadequate, for exactly the same reasons as in Latin America in previous decades: “Spending has actually been on a declining trend in many countries, partly as a result of the disproportionate toll that the fiscal adjustment of the 1990s took on public infrastructure spending, and also reflecting the fact that private sector participation has failed to live up to expectations”. A 2010 report on infrastructure investment in Africa found that the contribution of the private sector has been close to zero in water, electricity and transport: there has only been some private investment in telecoms. Despite this, African governments have been investing more than previously thought, and: “the public sector remains the dominant source of finance for water, energy, and transport in all but the fragile states”. If Africa caught up with the infrastructure investment levels of other world regions, growth rates would increase by 1–2%.<sup>48</sup>

The principal mechanism for financing infrastructure development, worldwide, is still through government and the public sector.

According to a global survey by Siemens in 2007, public–private partnerships (PPPs) only account for about 4% of all public sector investment: and public sector loan financing is expected to remain the main financing instrument throughout Europe. Private investors cannot be sure of getting a return high enough, despite the great benefits for the economy and society as a whole, as was noted in the 19th century: “A country, e.g. the United States, may feel the need for railways in connection with production; nevertheless the direct advantage arising from them for production may be too small for the investment to appear as anything but *sunk capital*. Then capital shifts the burden on to the shoulders of the state”. The same factor remains visible in telecoms in Europe, where private network operators are also reluctant to make sufficient investment in the fibre-optic networks which are crucial to greater use of the internet. So governments are having to provide public finance: in Portugal, for example, the state has provided 85% of the financing for a €1 billion investment programme. The 2020 strategy paper of the EU also demands more public finance, calling on governments: “To draw up operational high speed internet strategies, and target public funding, including structural funds, on areas not fully served by private investments”.<sup>49</sup>

Even in the USA, where the role of the state is relatively small, the great majority of investments in transport, education, and environment are public – and even 35% of utility investment is public sector, reflecting the dominant municipal role in the sector despite the high levels of private operation in electricity and gas; only in healthcare is the public proportion low.

**Chart G. Capital spending on USA infrastructure 2007**

Source: CBO 2009 *Subsidizing Infrastructure Investment with Tax-Preferred Bonds*  
<http://www.cbo.gov/ftpdocs/106xx/doc10667/10-26-TaxPreferredBonds.pdf>

One victim of the crisis has been the credibility of the orthodox neo-liberal economic wisdom, especially in the global south. The failure of this model contrasts with the positive social and economic developments in Latin America and India, based on social democratic policies with a strong role for the state, as well as the important role of public infrastructure investment in China's economic growth. So there is a marked shift in the terms of debate. Neoliberal assumptions are no longer regarded as sacrosanct.

One remarkable example of this is a speech in 2009 by the chief economist at the African Development Bank, which argued for a stronger developmental role for the state, with public infrastructure investment at its core:

The crisis should be grasped as a turning point in the development path of developing countries, particularly here in Africa. In order to overcome the continent's structural constraints and reduce its external dependence, it is necessary to reconsider the role of the state. The market only works through incremental changes and small steps. However, developing countries need to stimulate investments by socializing risk, in order to achieve long-term structural transformation. The market has not been and will not be able to carry out these changes alone.

The critical question now is not simply how developing countries can cope with the short-term immediate impact of the crisis. More important, the question is how can they emerge from the crisis in a stronger position? What policies should they be crafting now for the post-crisis era? ... Macroeconomic policies across the developing world during the last several decades have been strongly influenced by the recommendations of the international finance institutions and bilateral aid donors who, in turn, were heavily influenced by the neoclassical school ... As argued by several scholars, the reforms based on this approach have largely failed to develop the private sector as the driving force for development...

Public investment – especially but not exclusively in traditional infrastructure such as transport, irrigation and energy networks – has a key role to play in driving the development process. I believe that here in Africa, when the state just stands aside waiting for individual action and non-state forces such as entrepreneurship, comparative advantage, and cross-border capital inflows to bring development or transition, the result can be very negative, and in turn produce the sort of stagnation that can lock countries into their unfavorable positions in the world economy.<sup>50</sup>

## 4. Public spending and employment

Public spending supports employment in three main ways:

- direct employment of public service workers;
- indirect employment of workers, by contractors supplying outsourced goods and services;
- employment of workers on infrastructure projects.

The table below shows estimates of the proportion of jobs supported by public spending, including the additional jobs supported by the ‘multiplier effect’ of consumer spending. These are rough estimates of a global average, showing that:

- Public spending supports 40% of all jobs: 15% as public employees, but 25% in the private sector.
- Including public service utilities, public spending and public services support 50% of the jobs in the economy – twice as many in the private sector as in the public sector.

**Table 9. Global jobs supported by public spending and public services (as % of all employees)**

	Public employees	Private sector employees	Total
<b>Total public spending</b>	<b>15</b>	<b>25</b>	<b>40</b>
Public utilities (mixed)	2	8	10
<b>Total public services</b>	<b>17</b>	<b>33</b>	<b>50</b>

Source: OECD, CEEP, BERR, Scotstat, PSIRU calculations. For explanations, see notes. <sup>[1]</sup>

<sup>[1]</sup> The table is constructed as follows. Direct public employees: median from OECD GOV/PGC/PEM(2008)1 figure 8; Indirect jobs: using BERR estimate of 1.2million jobs supported by £79billion spending, implying a jobs:spending ratio of about half compared with direct labour (5.2million jobs from £160billion spending), and assuming that the ratio of non-service procurement (£67million) is half of that again, so the overall employment effect of 8% of GDP spent on procurement (the OECD estimate 2008) is to support just over one-third of the jobs that would have been supported as direct labour; employment effect of construction spending taken from Scotstat, implying a higher ratio of about two-thirds the effect of direct employment; public utilities, using an average of the CEEP figure 6% and the implied ILO figures of 4% and 2%. Multipliers for direct labour, construction and utilities are weighted averages of Scotstat multipliers for the relevant sectors, including induced effects: see <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Input-Output/IOAllFiles2004> ; for procurement, the BERR implied multiplier of nearly 2.0 is used.

There are other employment effects from public spending, which create, protect or improve jobs outside the public sector.

Governments use various subsidies to provide or support employment, either by subsidising private companies or by providing employment guarantees to workers; these are discussed in section 4.3.

Government procurement has been widely used to require ‘fair wages’ from private contractors, and also as an instrument to eliminate gender and ethnic discrimination and disadvantage. This is discussed in section 4.2.

In addition, spending on social security benefits creates extra demand, because it gives greater spending power to people who would otherwise have very low incomes: this extra spending means extra demand and extra jobs.

#### 4.1. Direct and indirect employment

Governments employ workers directly to provide public services and administer social security programmes, known as public employees. Counting the number of public employees is not straightforward. The numbers vary according to the definitions used of ‘government’ and the ‘public sector’, and there are variations between countries, depending on the overall level of public spending, the structure of the public sector, the extent of outsourcing, and the size of the formal economy.

In 1998 the International Labour Organization (ILO) estimated that the public sector accounted for about 21% of employees in high-income countries, and about 23%, in developing countries, including employees in state-owned enterprises. Restricted to just employees of central and local government and health authorities, these figures would be about 17% and 21%. These figures suggest that public employment is proportionately almost as significant in developing countries as in high-income countries, because formal employment is a smaller part of the economy as a whole.

In the EU, a recent analysis found that the providers of ‘services of general interest’ (public services and utilities such as water, electricity, post, telecom and public transport) employed more than 64 million persons in 2009, representing 30% of the total number of employees in the EU. The great majority of these were in services and sectors which are overwhelmingly carried out by public authorities: healthcare (with nearly 10% of all employees); and education and public administration (each about 7% of all employees). So in the EU, government employees represent about 24% of all employees – nearly 1 in 4 jobs – with another 6% in private or public jobs in other services of general interest.

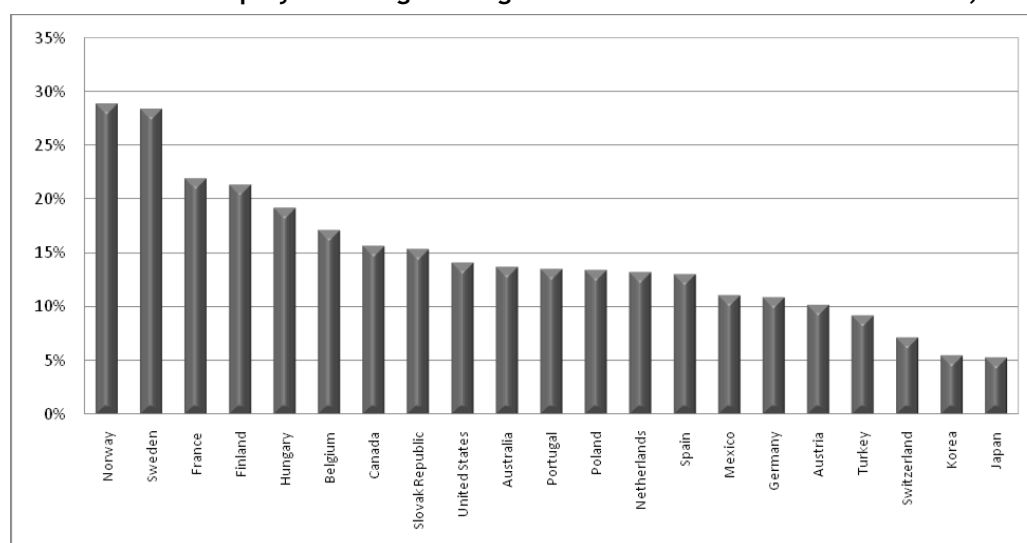
**Table 10. Employment in services of general interest in EU, 2009**

	As % of total employment
Health	9.6
Public administration	7.2
Education	7.0
Other	6.4
Total	30.1
Total (numbers)	64,720,000

Source: CEEP 2010<sup>52</sup>

A recent OECD survey found a wide range across countries. Expressed as a percentage of employees, the median is about 15%. It is lower than the average for EU countries, because it includes countries such as Korea and Japan, where levels of public spending and employment are relatively low, and does not include all EU countries. It also uses narrow definitions of ‘government’.<sup>53</sup>

**Chart H. Employment in general government as % of total labour force, 2005**



Source: OECD 2008<sup>54</sup>

Other public spending is used to buy goods and services from contractors. On average, in OECD countries, governments spend slightly less on this than on direct employment, amounting to about one-sixth of GDP – almost as much as on paying government employees. This spending supports jobs in the private sector. Estimates from the UK suggest that the number of jobs supported by this spending is under half the number supported by the same level of spending on direct jobs, because some of it goes on contractors' materials, and their profit. This implies that such spending supports a further 8% of all employment.<sup>55</sup>

Public investment on average normally represents a further 3% of GDP in OECD countries, supporting about 2% of all jobs, but can be much higher in developing countries. This kind of spending happens continuously, as a way of creating public assets and creating jobs. In Nigeria, for example, the state of Borno has undertaken a large housing programme, using government funds: it provides not only homes but also employment in building and maintaining the houses.<sup>56</sup>

For both direct and indirect jobs, there is a further 'multiplier' effect. Multipliers can vary between sectors and countries, and a set of official multipliers from the UK is used in the calculations for table 9 above.

#### 4.2. 'Fair wages' clauses and social procurement: international history and context

'Fair wages' policies have been applied to public sector contractors for over a century, in order to use the economic activity of public authorities to "create avenues of just and secure employment". In France, the USA, the UK and other countries, 'fair wages' legislation and clauses were introduced, specifying minimum conditions of work and/or the need to recognise rates agreed with trade unions. In 1892, the newly elected London County Council, for example, used clauses insisting on an eight-hour working day, and trade union rates.<sup>57</sup>

In the 20th century procurement developed as a key policy instrument for supporting the employment of disabled workers, and for eliminating racial, gender or religious discrimination. Many countries introduced clauses requiring contractors to apply equal opportunity policies. In the USA, for example, the civil rights movement led to the use of procurement preferences as part of 'affirmative action' policies to advance the economic status of groups who had suffered discrimination. Similar legislation has since been implemented in South Africa since the ending of apartheid. Procurement has also been used as an instrument of international solidarity, for example by excluding companies who were trading with the apartheid regime in South Africa. The EU itself included the principle of equal pay in the original Treaty of Rome, and procurement clauses were a key mechanism for enforcing this principle, through: "the adoption of linkage between procurement and non-discrimination requirements by several *Länder* (states) in Germany, several local authorities in the United Kingdom, and many local authorities in the Netherlands."<sup>58</sup>

The ILO adopted the principle of fair wages clauses in 1949, in Convention 94, which requires states to include clauses in their public contracts ensuring that wages (including allowances), hours of work, and other conditions of labour were not less favourable than those established for work of the same character in the trade or industry in the district where the work is carried out.<sup>59</sup> The ILO also adopted the use of procurement clauses for pursuing equality in Recommendation 111, which advocates that commitment to equality principles should be a condition of eligibility for public contracts. The ILO has also encouraged the use of social clauses as a mechanism for enforcing its core labour standards, especially to protect construction workers, and to improve conditions of employment in developing countries. An ILO report published in 2008 notes that the increased use of outsourcing – including through PPPs – and the use of labour-only subcontracting, make the problems even more acute now than when ILO 94 was first agreed.<sup>60</sup>

The development of these policies has often been resisted by commercial interests and right-wing political parties. The Thatcher government in the UK, for example, denounced the ILO convention, repealed the UK's fair wages law, and finally restricted the right of municipalities to apply social criteria. This reflected constant and successful lobbying by private companies, who wanted to undercut the pay and conditions agreed in the public sector. Employers organisations still attempt to resist fair wages clauses: the Confederation of Norwegian Enterprises argued against Norway's ratification of the ILO convention in 2008, and employers in Latvia argued against a procurement law which favours companies with good social insurance contributions on behalf of their employees.<sup>61</sup>



Despite these changes in international climate, fair wages clauses are still being used and introduced by countries as an instrument of social policy.

- In countries of central and eastern Europe the growth of illegal employment without social insurance or recognised pay and conditions is seen as a major problem by governments: Hungary, Slovakia and Latvia have all introduced for the first time new procurement laws which place conditions on the employment practices of companies tendering for public contracts.
- Public authorities in the USA continue to operate strong equality programmes favouring minority- or women-owned suppliers.<sup>62</sup>
- In Belgium new social clauses were introduced in the Brussels region in 1999.
- An international survey of procurement policies in 2007 found that public authorities are much more oriented towards social aspects of sustainable procurement – purchasing from small/local companies, and worker safety – rather than environmental issues (whereas private companies tend to focus only on environmental issues when presenting their corporate social responsibility statements).<sup>63</sup>

#### **Box D. Greater London Authority responsible procurement policy**

The Greater London Authority (GLA) spends over GBP £3billion (USD \$4.8billion) each year on procuring supplies, works and services. It has adopted a comprehensive social procurement policy which includes standard contract conditions on employment issues. The policy is applied not only through contract conditions but through a series of meetings with suppliers and community organisations to ensure the policies are understood and supported.

The GLA's responsible procurement policy consists of seven themes:

- encouraging a diverse base of suppliers;
- promoting fair employment practices;
- promoting workforce welfare;
- addressing strategic labour needs and enabling training;
- community benefits;
- ethical sourcing practices; and
- promoting greater environmental sustainability.

The GLA sets a 'London Living Wage' (LLW), significantly above the national minimum wage. In re-tendering its cleaning and catering contracts in 2006, bidders were required to indicate whether they would accept a LLW clause as part of the contract, including ensuring that other employment conditions were not reduced as a result of paying a living wage. It estimates that over 400 workers gained from implementation of the LLW in 2007.

The GLA applies 'supplier diversity requirements' on major contracts, such as the East London rail redevelopment, to ensure that smaller suppliers led by minority ethnic groups, by women and disabled people have received a significant proportion of subcontracts. It also monitors the supply chains of companies, for example suppliers of uniforms, and is piloting the use of a Suppliers Ethical Data Exchange (Sedex) – a system for companies to report labour conditions in all their suppliers factories.<sup>64</sup>

### **4.3. Employment subsidies and employment guarantee schemes**

Public spending is often used to subsidise companies as a way of protecting employment levels. One general method which has been used during the crisis has been through short-time working schemes, which compensate employees who agree to maintain employment levels by reducing working time: "usually relying on state-subsidised schemes that compensate employees for part of their loss of earnings resulting from reduced working hours." More specific subsidies are also used by governments, justified by

employment protection, for example through the ‘scrappage’ schemes to encourage purchases of new cars and so protect jobs in the motor industry.<sup>65</sup>

‘Employment guarantee’ schemes work by providing direct payments to workers themselves who would otherwise be unemployed. This has been used in a number of countries, usually involving employment on public works or infrastructure. After the economic crisis of 2000, Argentina introduced a scheme guaranteeing 20 hours work a week to a member of households with children under 18. They not only provide employment and income to eradicate poverty, they also have a multiplier effect on local economies by enabling greater consumer spending, and by improving local infrastructure.

#### **Box E. India: the National Rural Employment Guarantee**

The biggest scheme is in India, known as the National Rural Employment Guarantee (NREG). An employment guarantee scheme had existed in the state of Maharashtra for many years, and in 2005, against the background of widespread rural poverty, the government of India introduced a national scheme. This guarantees 100 days of work to one member of a rural household, on works decided locally as being of value to the community. It thus creates rights which strengthen the bargaining position of rural workers, and is demand driven. The scheme includes requirements for basic employment conditions, including a basic hourly minimum rate, a 7-hour day, a weekly day off, equal wages for equal work, medical and crèche facilities.

In 2009–2010, the scheme provided work to over 52 million people, 48% of whom were women. It cost about 389 billion rupees in 2009/10 (about USD \$8.5 billion). Because of the level of the minimum wage set by the scheme, and the scheme itself, there was a general affect on rural household incomes, which increased by 50% in 2 years.<sup>66</sup>

## 5. General support for industry

Significant parts of public services support other economic activity by the private sector. These include the provision of a legal system, courts and police, which both protect property rights and provide ways of enforcing contracts. The modern company itself is a legal entity dependent on privileges given by the state, including ‘limited liability’ which allows companies to fail and go bankrupt without the individuals running them being liable to any of the firm’s creditors.

Virtually every sector in modern economies relies on significant economic support from the state. In some sectors, in many countries, this takes the form of public ownership – for example of public transport, electricity and water – and, in many more countries now, of banks and financial institutions. Many sectors depend on public spending for contracts for goods and services, which represents about 16% of GDP in high-income countries. This includes many firms in the production sector, such as arms manufacturers or pharmaceutical companies, both of which rely principally on government orders. Some firms in the services sector also benefit, as a result of outsourcing policies, for example in auditing, IT, or cleaning services.

There is also a set of sectors where governments provide guarantees, or subsidies, or finance on favourable terms, without which companies would be less likely to function. One example is the public works businesses of the construction industry which are linked to PPPs that, in effect depend on long-term guarantees of government payments if they are to be financable. Governments and development banks lend money to companies at rates which they could not obtain commercially. Implicit and explicit guarantees are given to customers of European banks during the crisis, which make every bank a ‘safe’ place to hold an account. Subsidies are provided for rail and bus fares, housing rents, green investments for energy efficiency. Systems of regulation, for example in electricity, favour companies by providing them with much greater certainty about prices and revenues, which reduces risks.

Research and development, too, is government funded to a greater or lesser extent in many sectors, either through universities, or funds to companies, or directly through state-owned operators. Even within liberalised electricity markets, for example, it is only the state-owned companies which invest in R&D:

The last two decades have witnessed a staggering decline of R&D investment in the fields of energy and electricity ... The drop of research expenditures was particularly strong among the private or newly privatised companies, while those that remained under public control did not reduce R&D efforts. <sup>67</sup>

**Table 11. Economic links between public spending and sectors of economy**

Sectors*	Direct ownership and provision	Procurement	Investment, subsidy, guarantee	Examples
A – Agriculture	x	x	x	Farm subsidies in EU, USA, Japan etc.;
B – Mining			x	Concessions and subsidies
C – Manufacturing	x	x	x	Arms purchases, medical equipment, drugs etc. ; motor industry bailouts, ‘scrappage’ schemes;
D – Electricity, gas	x		x	Public utilities; subsidies for green energy; public finance for transmission lines
E – Water and sewerage	x		x	Public utilities; public finance for investments;
F – Construction		x	x	Road, rail, bridges, tunnels, housing; PPP guarantees
G – Wholesale and retail trade	x			Public markets
H – Transportation	x	x	x	Public rail and bus; outsourced services; fares subsidies
I – Accommodation and food	x	x		In-house and outsourced catering services
J – Information and communication	x	x	x	Publicly owned telecoms and cable; outsourced computing services; public finance for fibre-optics
K – Finance and insurance	x		x	Publicly owned banks and insurance companies; bailouts, guarantees for account holders, PPPs
L – Real estate	x		x	Public housing; subsidised housing

M – Professional services	x	x	x	Government scientists, legal services etc.; outsourced services; R&D subsidies
N – Administrative services	x	x		Employment agencies; security and building services
O – Public administration	x	x		Central and local government, social security systems; outsourced services
P – Education	x		x	Public education; subsidies and tax relief for private schools
Q – Healthcare	x	x	x	Public healthcare, outsourcing, benefits and subsidies
R – Leisure	x		x	Museums and libraries; arts subsidies and tax relief

\*Sectoral classification as per UN ISIC-4

#### Box F. General Motors and public finance

The case of General Motors (GM) shows that the benefits of public ownership, and the problems of weak public services, affect large manufacturing companies as well as the general public. GM was the largest manufacturing company in the world, and still employs nearly 240,000 workers, but it had to be rescued from bankruptcy in 2009 and is now owned by the American and Canadian governments, and a fund owned and run by a trade union. In late 2010 GM is planning a partial re-privatisation by selling about a fifth of its shares on the stock exchange.

GM was rescued by large amounts of public finance. The American and Canadian governments gave \$61 billion in public finance to GM to help it avoid bankruptcy. Most of this was converted into shares, so that in July 2009 GM became 61% owned by the USA government, and 11% owned by the Canadian government.

GM also asked European governments to give the company up to €3.3 billion in loan guarantees to help finance the restructuring of its Opel division. In June 2010 the company withdrew the requests and acknowledged that it did not need this state aid.

Nearly 20% of shares in GM are controlled by the main union, the United Auto Workers (UAW). The ultimate reason for this is that the USA does not have a good comprehensive public health service, so that healthcare benefits are an important part of employment contracts, and a significant extra cost to employers. The union shares are owned by a healthcare trust fund, VEBA, which was created by the union to take over responsibility for financing the healthcare for retired employees of GM (and other car makers including Chrysler and Ford). GM gave VEBA 17.5% of its shares and over \$18 billion to take over these liabilities; Chrysler and Ford have paid another \$17.6 billion.<sup>68</sup>

## Section II: Social and environmental functions of public spending

The social function of public spending can be considered as allowing greater development of social and individual capabilities. Healthy and educated people have a much greater potential for developing their own capacities, which is central to social development, as argued by Amartya Sen, the Indian philosopher and economist, and winner of the Nobel Prize for Economic Science.<sup>69</sup> This section of the report looks at how public spending does that in three ways:

- through increasing equality, so that the benefits of economic resources are far more equally shared;
- through greater effectiveness at providing a service of value to society, such as healthcare;
- through protection of the environment and development of renewable energy.

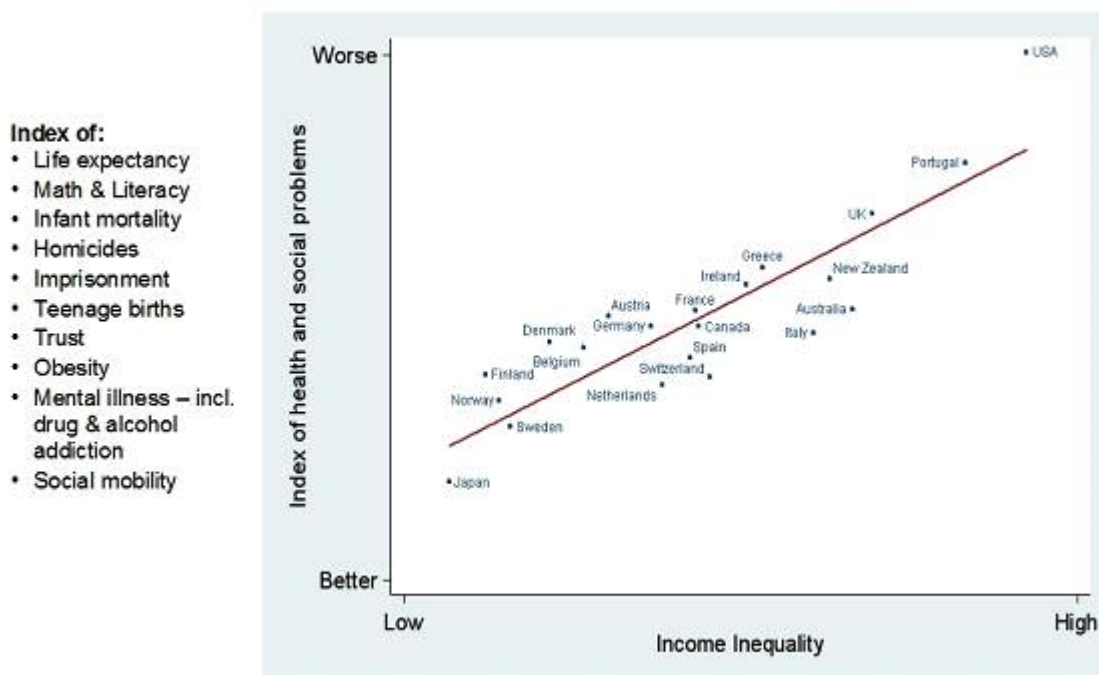
### 6. Public spending and equality

#### 6.1. Public services and equality

Greater equality is better for everyone. A recent book, *The Spirit Level*, uses international data to show that more equal distributions of income lead to a better life for everyone. Life expectancy is higher, infant mortality is lower, there are fewer murders, less mental illness, less obesity, and less people in prison.<sup>70</sup> But markets create very unequal distributions of income, so that the top 10% have very high incomes, while the poorest have very little. In order to get the benefits of greater equality, there have to be mechanisms based on solidarity, to enforce a fairer distribution of resources. Together with trade union organisation, which can raise incomes based on wages as opposed to income based on profits, public spending is the great mechanism for achieving greater equality.

Chart I. Health and social problems are worse in more unequal countries

#### Health and Social Problems are Worse in More Unequal Countries



Source: Wilkinson & Pickett, *The Spirit Level* (2009)

www.equalitytrust.org.uk

Equality Trust

Public spending plays an obvious role in the redistribution of income. Taxes are paid by people according to their income or spending, and benefits are paid to people who are unemployed or retired or caring for children (see section 6.3). But public spending on services also has a very powerful redistributive effect. In particular, public health services and public education have a similar impact to the social security system. This is clear in high-income countries, where public services are largest. A study of 7 EU countries found that the value of public services is about one-third of total disposable income, and far more equally distributed. The same effect is also important in developing countries, where the direct provision of public services is the greatest form of equalisation, and social security benefits have a relatively smaller role.<sup>71</sup>

The table below presents figures showing how this works in the UK. The distribution of ‘original’ income – before any state intervention – is highly unequal, with the average income of the top 20% about 15 times greater than that of the poorest 20% of households. This is what the market delivers. The table then adds incomes from benefits, which go mainly to poorer households – this improves equality significantly, more than doubling the income of the poorest 20%, so that the top-to-bottom ratio falls to 7%. This is what is commonly expected.

The next stages are more surprising. Taxes are taken away, reducing the income people have left to spend. Direct taxes on income take most from the top groups – but indirect taxes, such as VAT, take a much bigger proportion of the income of the poorest. The net result is that after all taxes have been paid, the distribution of income is almost unchanged – the top group still have about seven times as much as the poorest group. So overall, the tax system in the UK is not very progressive.

The final step quantifies the benefit of public services, most importantly, education and health. The value is calculated according to how much each group uses the service, and poorer households get greater benefit because they include more children and more people vulnerable to ill-health, such as pensioners (although the top groups gain most from transport subsidies). The value of these services to the poorest group is almost as great as all their after-tax cash income from pay and benefits put together. The effect on inequality is as dramatic as the effect of benefits – the top-to-bottom ratio falls from 7 to 4.

**Table 12.      Redistribution of income through taxes, benefits and public services: UK, 2008/09**

(£ per year)	Bottom	2nd	3rd	4th	Top	All households	Ratio Top/Bottom quintile
Original income	4 970	12 020	23 305	38 321	73 810	30 485	15
<i>plus</i> cash benefits	6 431	7 602	5 787	3 609	1 805	5 047	
Gross income	11 401	19 622	29 092	41 930	75 615	35 532	7
<i>less</i> direct taxes	1 270	2 523	5 046	8 798	18 255	7 178	
<i>less</i> indirect taxes	2 862	3 592	4 316	5 579	7 354	4 741	
Post-tax income	7 269	13 507	19 731	27 553	50 006	23 613	7
<i>plus</i> benefits in kind (health, education etc.)	6 315	6 411	5 969	5 000	3 870	5 513	
Final income	13 584	19 918	25 699	32 553	53 876	29 126	4

Source: see note <sup>72</sup>

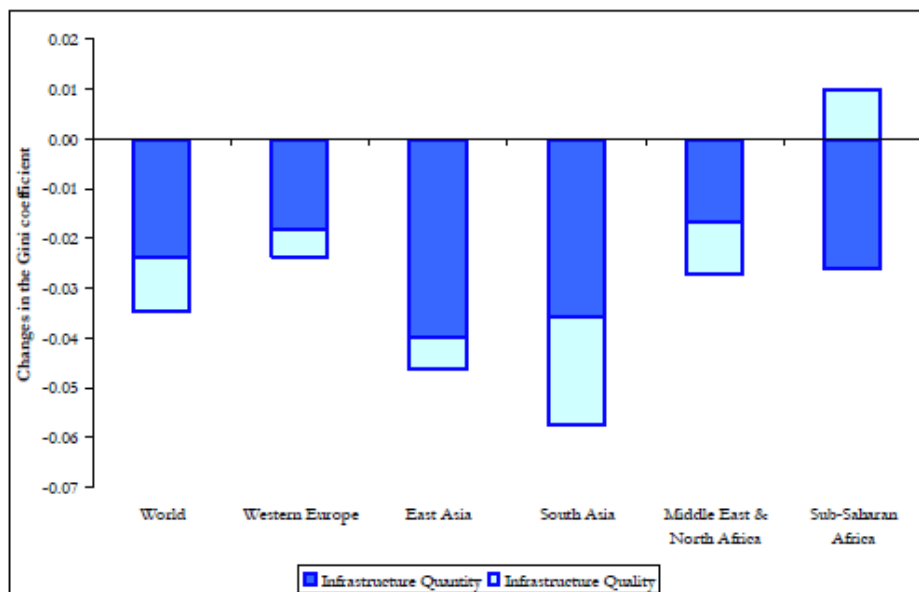
This redistributive effect of public spending and public services is especially important because of the growing inequality between the shares of profits and wages in the economy as a whole. There has been a long-term decline in the share of wages in Europe, the USA and Japan over the last 35 years. This decline means that workers have gained little even though productivity has risen massively. In the USA, for example, in the quarter century between 1980 and 2005, productivity increased by 71% while earnings rose only 14%. At the same time inequalities between the top and bottom incomes increased. The share of all income taken by the top 1% of people doubled from 8.4% in 1980 to 17.4% in 2005 <sup>73</sup>. Part of this process is linked to privatisation, which moves economic activity from the public sector, where the share of wages is high, to the private sector, and so: “As a consequence of privatisation and deregulation, capital has gained at the expense of labour, almost everywhere, for profit shares have risen while wage shares have fallen.” <sup>74</sup>

## 6.2. Infrastructure and equality

Infrastructure investment is not only necessary for economic development, it has a direct impact on inequality of income. As people gain access to roads and electricity and telecoms, they have better opportunities for earning more, and so people on lower incomes gain more than those on higher incomes.

Recognition of these gains has been an important factor in the democratic processes of India, where the slogan of 'bijli, sadak, pani' – electricity, roads, and water – is widely used in election campaigns, because voters recognise the importance of these factors: household surveys in a number of different states provide systematic evidence that these infrastructures rank at the top of voter demands, alongside education.<sup>75</sup>

**Chart J. Improvements in equality due to infrastructure development, 1990s-2000s, by region**  
Change in Gini coefficient between averages for 1991–1995 and 2001–2005



Source: Calderon and Servén 2008<sup>76</sup>

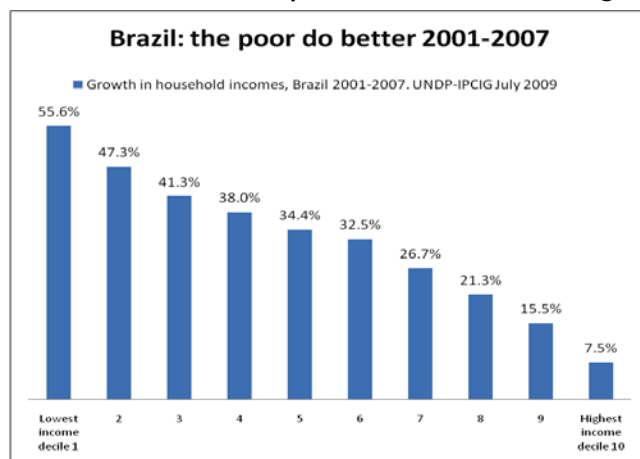
## 6.3. Benefits and equality

Social security systems provide support to the vulnerable and the poor by providing benefits to raise incomes. These systems are well-established in high-income countries, which spend on average 13% of GDP on providing pensions to the old, child benefits to the young, and unemployment benefit to those without jobs. Benefit systems are basically redistributive, and so in principle are affordable for all groups of countries: “The cost is within reach of even the poorest countries, while making it affordable requires political will”.<sup>77</sup>

The potential effects are considerable, as shown by the example of Brazil. The country has been one of the most unequal societies in the world, but it is becoming significantly more equal as a result of new government policies on public spending. Inequality, as measured by the Gini coefficient, fell from 0.59 in 2001 to 0.53 in 2007. Public spending has been crucial to this process: one-third of this greater equality is due to improved access to education, one-third is due to improved state benefits and minimum wage levels.

This greater equality has helped reduce the impact of the recession: “One reason why the financial and economic crisis did not hit Brazil as hard as other countries may be the growing domestic market and changes in the structure of demand created in the last decade. These, in turn, were spurred by this virtuous pattern of improved income distribution.”<sup>78</sup>



**Chart K. Brazil: poor household incomes grow fastest 2001-2007**

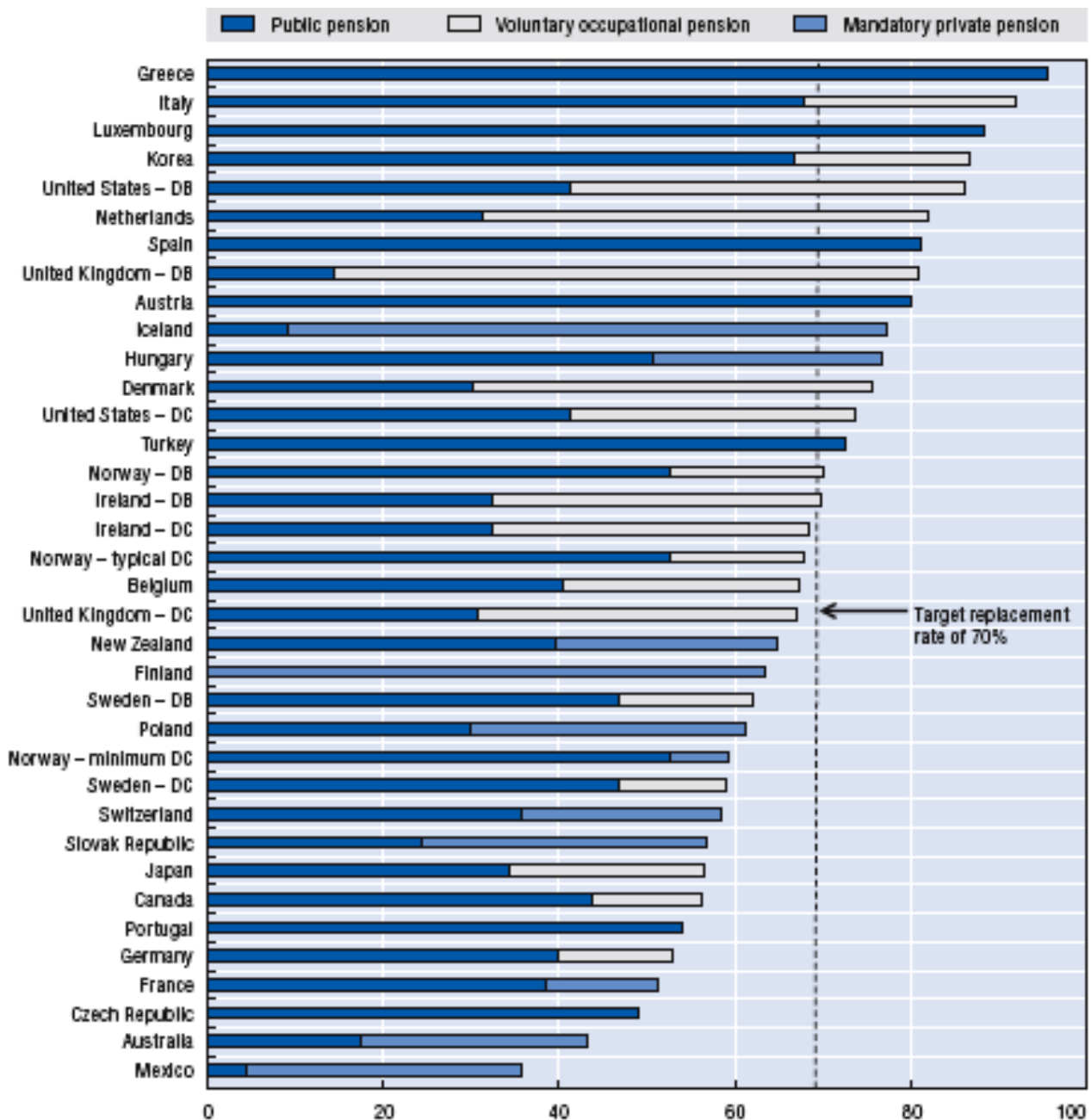
Source: see note <sup>79</sup>

Pensions are also becoming increasingly important in developing countries. Private schemes work only for those with enough money to save, so state provision is necessary to reduce poverty. Contributory schemes do not help many women or those who have worked in the informal economy, and means-tested benefits in practice exclude too many people. The most effective way of providing pensions to eliminate poverty among the elderly is through universal flat-rate pensions financed from general taxation. Universal pensions also provide women with an equal pension, where they have not had the same opportunities as men for paid employment. Among developed countries, New Zealand has done this, and been exceptionally successful at eliminating old age poverty.

Similar schemes in developing countries also work – e.g. in Mauritius, where the poverty rate in elderly households has been reduced from 30% to 6%, and in Namibia, where a universal pension is the main source of income for many elderly people. Such pensions are affordable, even in developing countries. The scheme in Botswana costs 0.5% of GDP; in Mauritius 1.7% of GDP; in Nepal, just over 1% of GDP. <sup>80</sup>

In high-income countries, there is a range of complex public and private provision for pensions. Both the IMF and the European Commission claim that public finance for pensions has to be reduced, because of the ageing of the population in northern countries (see Section III). But even in OECD countries, the state pension is far more important as a way of providing a decent level of pensions, as shown in the chart below.

Chart L. Pensions as a proportion of workers' incomes, from state and private schemes



Source: OECD Benefit adequacy [www.oecd.org/daf/pensions/outlook](http://www.oecd.org/daf/pensions/outlook)

## 7. The effectiveness of public services

The general advantages of public spending are partly due to the relative efficiency of public services as a way of delivering services of benefit to society as a whole. This can be seen by examining specific services.

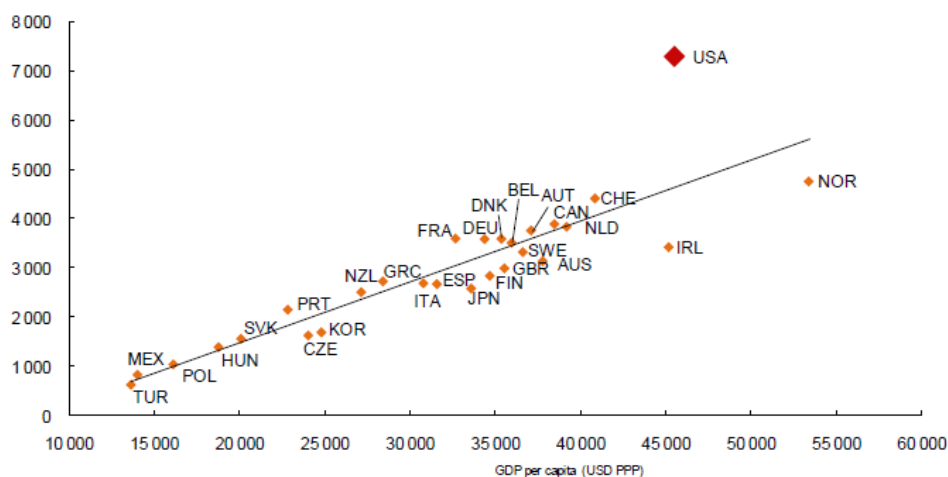
This section of the report sets out the relative advantages of public healthcare, showing how much more efficient and effective it is than a system based on private healthcare, followed by a note on how public housing offers a more efficient way of providing homes than forcing everyone to try and buy in the market, a system which led to unsustainable sub-prime mortgages.

### 7.1. The efficiency and effectiveness of public healthcare

Spending on healthcare is higher in countries where GDP is higher, as shown in the graph below. The data includes both public and private spending, but public spending represents the great majority in all OECD countries, except Mexico and the USA. There is good reason for this.

Comparative data on the USA and other OECD countries shows that a healthcare system based on private spending is *less efficient* and *less effective* than systems based on public finance. As a result, public spending on healthcare has a positive effect on economic growth, but private spending on healthcare does not.<sup>81</sup>

**Chart M. Health expenditure per capita and GDP per capita, OECD countries, 2007**



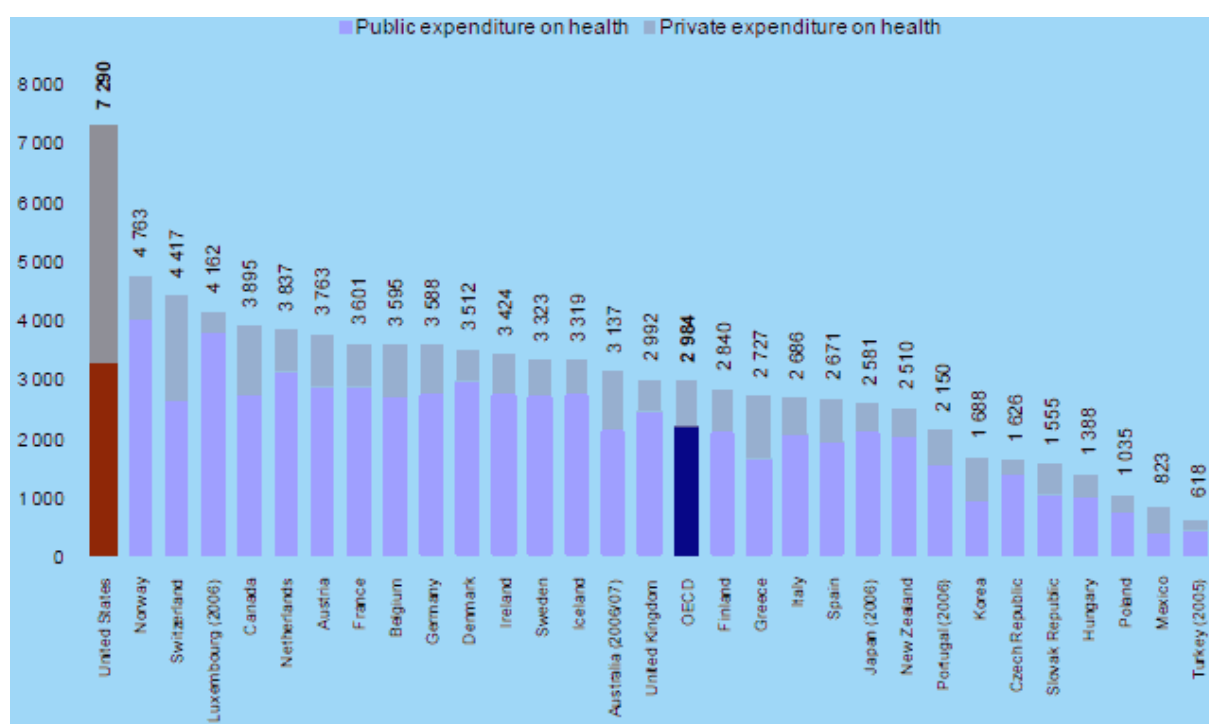
Source: OECD Health Data 2009

The USA's healthcare system shows the inefficiency of private healthcare. Its data stands out for two reasons. Firstly, the majority of spending is based on private insurance and private provision, supplemented by a range of government subsidies. Secondly, its total expenditure on healthcare is abnormally high. In 2007 the USA spent 16.0% of GDP on healthcare, far ahead of any other OECD country and nearly twice the OECD average of 8.9%. This is not due to greater needs: for example, only 12.5% of the population is over 65, compared with 16.7% in Europe and 21.5% in Japan; and people are no more likely to be sick than in other OECD countries. The excess expenditure is a result of much higher prices charged for branded drugs and hospital procedures; much greater use of diagnostic tests such as scans and some surgical operations; and higher spending on administration.

This higher spending does not produce better results: there is no evidence of any medical gains from the additional operations and tests; USA pharmaceutical companies are less innovative than European companies; and there is much lower use of computer technology such as electronic

patient records. It is thus, in economic terms, far less efficient than the public healthcare systems of other countries.

**Chart N. Health expenditure (public and private) per capita, US dollars, 2007, OECD**



Source: OECD Health Data 2009

The system is also far less effective: in 2006 the overall life expectancy in the USA was 78.1 years, lower than all OECD countries of similar wealth, and below some developing countries including Cuba and Costa Rica. The USA infant mortality rate was 6.7 deaths per 1000 live births – worse than all other OECD countries except Mexico and Turkey, and more than double the rate in the Czech republic, Finland, Iceland, Japan, Norway, Portugal and Sweden. Of all OECD countries, only the USA, Mexico and Turkey have not achieved universal healthcare coverage.

In the absence of a publicly financed health service, collective financing for healthcare may fall on employers either through legislation or through collective action by workers. In the USA, healthcare benefits are important elements in collective bargaining, and a key benefit of union organisation, because unions negotiate employer-funded schemes to provide security against ill-health. The cost of this insurance then appears as a higher level of indirect labour costs, on average 12% of total wages. This is a similar effect to employer contributions to social insurance schemes, except that it is not uniform across employers and not compulsory. Companies are thus at a disadvantage compared to companies in countries where healthcare is publicly financed.

**Table 13. Infant mortality, Deaths per 1000 live births, 2006, OECD**

Australia	4.7
Austria	3.6
Belgium	4.0
Canada	5.0
Czech Republic	3.3
Denmark	3.8
Finland	2.8

France	3.8
Germany	3.8
Greece	3.7
Hungary	5.7
Iceland	1.4
Ireland	3.7
Italy	3.7
Japan	2.6
Korea	4.1
Luxembourg	2.5
Mexico	16.2
Netherlands	4.4
New Zealand	5.2
Norway	3.2
Poland	6.0
Portugal	3.3
Slovak Republic	6.6
Spain	3.8
Sweden	2.8
Switzerland	4.4
Turkey	22.3
United Kingdom	5.0
United States	6.7

Source: OECD Health Data 2009

## 7.2. Housing and the crisis

The financial crisis originated partly from the problem of ‘sub-prime’ mortgages. In the USA, in particular, poorer families had to try to buy homes by taking out mortgages from banks which were trying to expand their business. The banks loosened credit requirements, as they rushed to sign more people to mortgages. Many people could then not afford the payments, and so these ‘sub-prime’ mortgages became bad debts for the banks, a major factor in the banking crisis. And many others were encouraged to refinance their houses, allowing them to borrow more against the equity of the ‘unrealised’ increase in the value of their houses. This additional borrowing fuelled the consumption spree in the USA, keeping the economy healthy, yet preparing the crisis in the housing sector. When home values fell, many people who had refinanced found they owed more than their houses were worth. They too became unable to pay the mortgages. The banks responded with repossessions which made hundreds of thousands homeless.

These problems arose in part because countries had abandoned, or never developed, public housing policies aimed at providing affordable, decent housing to everyone. The provision of public sector housing at affordable rents was one of the major public services in the 20th century. In parallel, non-profit mutual savings banks and building societies enabled the middle classes to buy houses, with encouragement and support from governments. From the 1980s, public sector housing was cut back as part of the general reduction in the role of the state. At the same time, mutual building societies were converted into for-profit banks, with fewer restrictions on their lending policies. The policies were followed in some of the richest countries (such as the USA); in countries in transition from communism where large public housing stocks were privatised; and in some of the least developed (such as Malawi), where a 2007 survey found that “Formal housing finance in Malawi is rudimentary ... and less than 16% [are] able to afford a conventional house ... no subsidies are available to the individual”<sup>82</sup>

The role of public housing services is being rediscovered, especially by UN agencies. The UN Economic Commission for Europe (UNECE) organised a conference in 2004 on housing problems in transition countries in central and eastern Europe, which concluded that:

... the increasing reliance on market forces has not been sufficient to compensate for the decline of the role of the state in the housing sector. For this reason, the housing needs of the poor and vulnerable are often not adequately addressed. The availability of affordable housing, however, is

crucial for an individual's well-being as well as for ensuring a social cohesive society. It is also an important factor for economic productivity: affordable housing is a prerequisite for labour mobility and an essential part of the creation of a policy environment conducive to enterprise formation and job creation. Realising this, countries are increasingly searching for ways to effectively and efficiently address the housing concerns of those most in need, and the provision of social housing is an important tool to achieve this.<sup>83</sup>

Housing is also a key issue in the slums of the rapidly growing cities of developing countries. This problem has been successfully addressed by public housing policies over the last 50 years in Singapore and Hong Kong, two of the most densely populated cities in Asia. In both cities, the programmes were started to deal with the problem of rapidly growing slum settlements, building hundreds of thousands of homes for rent. Public housing was later used to provide middle class housing as well, without rent subsidies. In Singapore, 85% of the population live in public housing, either rented or on a 99-year lease. Policies ensure that estates and new developments include a mix of different racial and social groups. Half the population of Hong Kong – over three million people – live in public housing; two million of them renting.<sup>84</sup>

The global financial crisis has thus sharpened the need to rediscover the value of social housing. At the height of the crisis, in October 2008, the UN released a statement by its housing expert, Raquel Rolnik, arguing that the crisis shows markets alone cannot ensure housing for all, and demanded a re-appraisal of social housing policies:

The belief that markets will provide adequate housing for all has failed. The current crisis is a stark reminder of this reality, ... A home is not a commodity – four walls and a roof. It is a place to live in security, peace and dignity, and a right for every human being ... Excessive focus on homeownership as the one and single solution to ensure access to housing is part of the problem ... adequate housing for all is a public goal whose achievement requires a wide variety of arrangements, from tax advantages to buy a home to better legal protection for tenants and rent control areas; from direct subsidies to the poor to publicly owned housing and a range of tenure arrangements. Markets, even with appropriate regulation, cannot provide adequate housing for all.”<sup>85</sup>

This was followed by a statement from the Executive Director of the United Nations Human Settlements Programme (UN-Habitat), Anna Tibaijuka, who told a UN-Habitat Committee meeting that:

Rapid, chaotic urbanization and the dearth of affordable housing were the underlying causes of the current financial crisis, and they could only be resolved through public financing and political will ... housing was the repository of national wealth, as well as a market product and a social good.”<sup>86</sup>

### **7.3. Environment: public funding to address climate change**

The greatest single challenge facing the countries of the world is dealing with climate change. The measures required include switching to renewable energy sources for generating electricity, investing in more energy-efficient industrial processes and more energy-efficient homes, and developing public transport systems to reduce the use of cars.

The global costs of all the measures required to cut carbon emissions by the necessary amount is estimated at between 1% and 3% of global GDP. The UN estimates that about three-quarters of this will have to come from public finance. These figures mean that globally, public spending will have to be higher by about 1.5% of total GDP, just on account of actions to deal with climate change.

The process has already started. The stimulus packages introduced by governments to counter the recession include many 'green' investment projects, estimated to be worth over \$436 billion in total – all from public finance. This part of the stimulus packages will not be phased out when the crisis is over: spending will have to continue at this level, and higher, for decades, in order to counter climate change.

The process of moving to sustainable energy patterns will itself create jobs. It is estimated that in the USA \$1billion of government spending on green energy projects will create 33,000 jobs. Groups of trade unionists in a number of countries have developed proposals for public investment programmes of energy efficiency, public transport, and development of renewable energy sources, which could create a million jobs per year.

Developing countries require investment of \$100billion per year by 2020, according to the UN Climate Summit (COP15) in Copenhagen, December 2009. The IMF estimates that 60% of this must be provided from public finance, through a combination of: (a) governments giving public finance as ‘initial capital’ for a green fund; (b) increased borrowing by issuing new government bond; (c) public finance to subsidise grants and cheap loans; and (d) new tax revenues e.g. through carbon taxes.<sup>87</sup>

At the same time, in developing countries, the process of electrification itself needs to be extended – requiring a further USD \$35billion per year, and needing both public finance and aid finance to support it. It will create extra demand for electricity, but at the same time it will replace the inefficient and polluting diesel generators which are widely used in many countries in both urban and rural areas where electricity connections do not exist. Further efficiencies can be gained through use of public procurement. For example, in both Uganda and Vietnam “the bulk procurement of 1 million compact fluorescent lamps substantially reduced the cost of the lamps and cut peak demand by 30 megawatts.”<sup>88</sup>

These policies require coherent planning and financing in a way which the market cannot deliver. One consequence is that public authorities are beginning to suggest that the liberalisation of electricity markets in the north may have to be reversed (see box). Even within liberalised markets, it is only the state-owned companies which invest in research and development (R&D); the private sector does not invest in R&D:

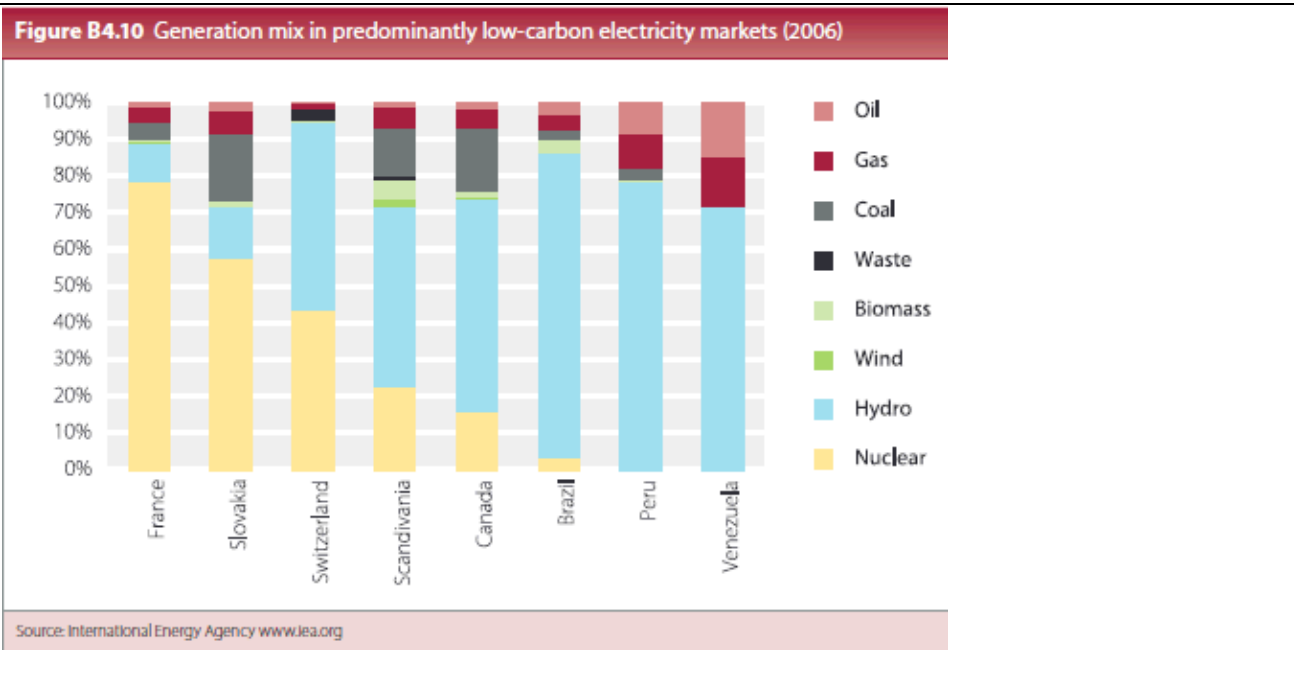
The last two decades have witnessed a staggering decline of R&D investment in the fields of energy and electricity. This paper contends that this widespread phenomenon is mainly ascribable to the processes of liberalisation and privatisation of electricity markets which have induced electric utilities to dramatically reduce R&D expenditures. However, a closer inspection to recent data concerned with ten major electric companies of the world shows that not all of them behaved in the same way. The drop of research expenditures was particularly strong among the private or newly privatised companies, while those that remained under public control did not reduce R&D efforts.<sup>89</sup>

#### **Box G. Renewable energy**

Official bodies in EU countries are beginning to question whether the necessary investment can be delivered under a liberalised electricity system, because historically low-carbon energy has only ever been delivered by state investment. A UK report in 2009 pointed out that countries with a high proportion of non-carbon generation have built their capacity through large-scale government investment, not through markets, and concluded that: “Several countries already source over 70% of their power generation from low-carbon sources. For these, investment has typically only occurred with substantial government intervention, even where markets have subsequently been liberalised ... We should not accept the significant risks and costs associated with the current market arrangements [in the UK and EU]: changes to the current arrangements are both required and inevitable.”<sup>90</sup>



Chart O. Countries with low-carbon electricity systems



## Section III: Paying for public spending: taxation



"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."

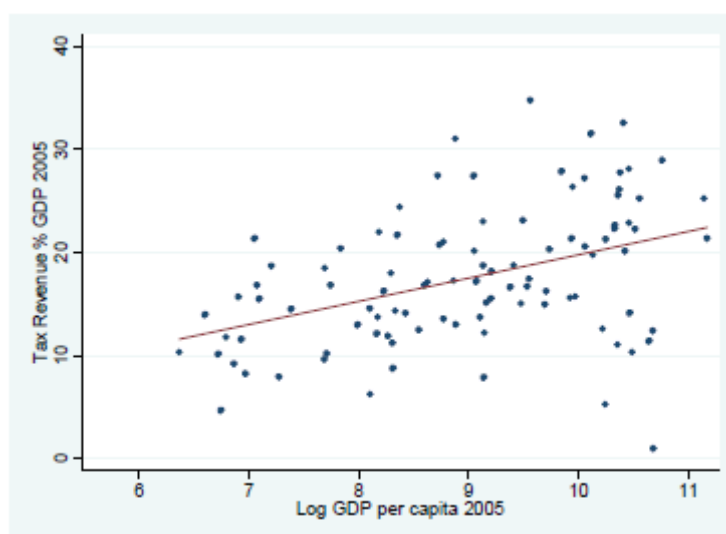
Pranab Mukherjee, India's finance minister, budget speech, July 2009

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. It finally looks at the illusory and damaging use of public–private partnerships (PPPs) to try and hide public borrowing.

### 8. 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.”<sup>91</sup>

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 increased most, but these are the least progressive taxes, which hit the poorest hardest. Direct taxes on income 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 P. Tax revenues as % of GDP rise as GDP rises**Source: DIE 2009 <sup>92</sup>**Table 14. 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](http://www.oecd.org/ctp/taxdatabase)**Table 15. 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 <sup>93</sup>

## 9. Fairness: the burden of taxation

### 9.1. 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; and
- income from international aid (or regional solidarity funds within the EU);
- 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, so that the burden grows as people's income and wealth rises. The key progressive taxes are income tax, corporation tax, and property tax.

**Table 16. Sources of public revenue**

	Progressive	Type	Example
Taxation	Yes	Income tax	Income tax
	No	Sales/consumption tax	Value added tax (VAT), petrol tax
	No	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.<sup>94</sup>

**Table 17. 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<sup>95</sup>

#### Box H. 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:

- 2.5% of VAT is reserved for education;
- 2.5% of VAT is reserved for social health insurance;
- 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 rice, poultry and vegetable cooking oil.

## 9.2. 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.<sup>96</sup>

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.<sup>97</sup>

**Table 18. 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

Roy Bahl 2009<sup>98</sup>

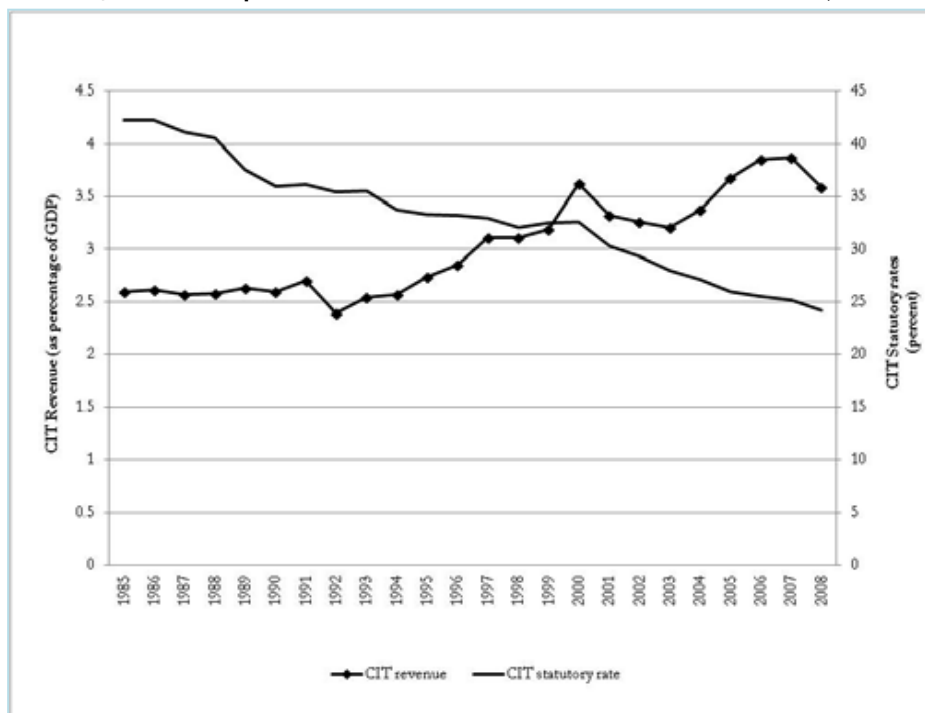
## 9.3. Corporate taxation

Companies should pay far more in taxes than they do now. Their profits take about one-third of the economy, but they pay taxes worth less than one tenth of those profits. 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.<sup>99</sup>

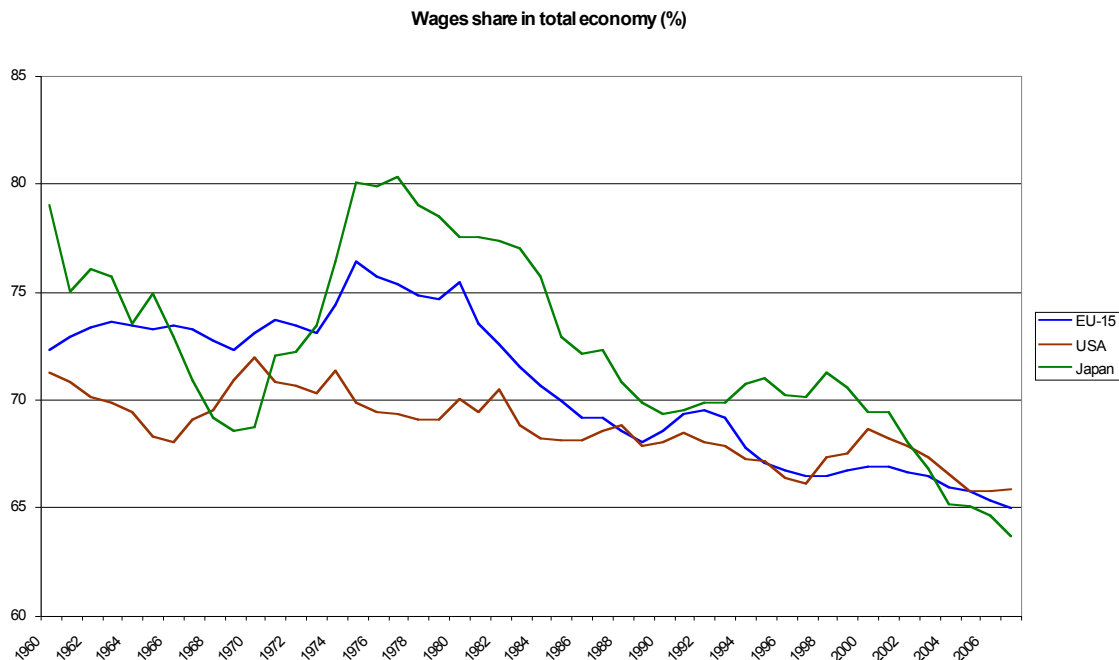
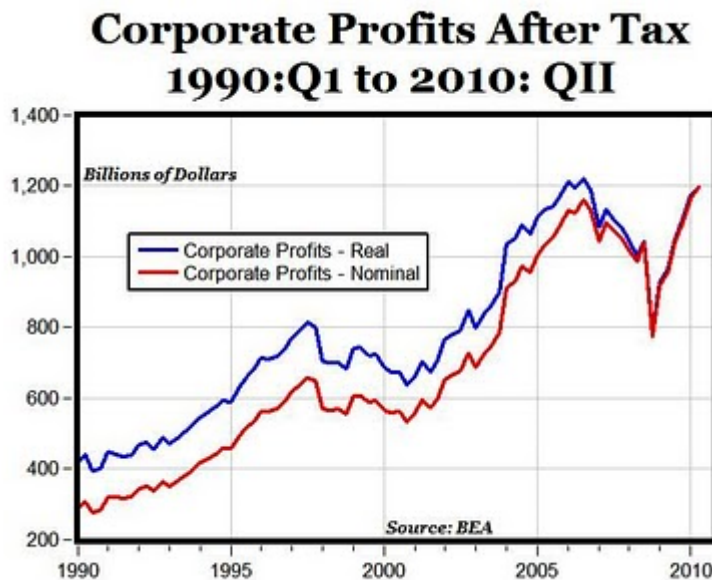
Whether through political pressures, or simply via forms of tax evasion, the revenue from corporate income tax has fallen from about 4.2% of GDP in 1985 to about 2.4% of GDP in 2008. Over this same period, corporate profits have increased their share of GDP in the major OECD countries, so that it now represents about 35% of GDP, compared with only about 25% in the early 1980s. Yet the effective rate of tax paid has halved. If corporations were still paying at the same effective rate as in 1980, they would be contributing tax equivalent to about 5% of GDP. Instead, half of that amount of revenue is lost, and has to be found from other sources.

The low level of tax contributions from company profits is now a more glaring issue. Corporate profits have not only recovered from the recession by mid-2010, they have reached all-time record levels.

**Chart Q. Corporate Income Tax Revenue in OECD countries, 1985-2008**



Source: IMF 2010<sup>100</sup>

**Chart R. Wages/profit shares in GDP, EU/USA/Japan, 1960 to 2008****Chart S. Corporate profits USA 1990-2010**

Source: BEA and Haver Analytics 2010 <sup>101</sup>

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”.<sup>102</sup>

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-needed 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”. And 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.<sup>103</sup>

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.<sup>104</sup>

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.<sup>105</sup>

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.

#### **Box I. 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.<sup>106</sup>

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.<sup>107</sup>

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.<sup>108</sup>

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.<sup>109</sup> 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.<sup>110</sup> There is also discussion of a global environmental tax, to help finance the response to climate change.

#### **9.4. 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 is obviously higher than in cities. Postal services 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 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 19. 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<sup>111</sup>

**Table 20. 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)<sup>112</sup>

## 9.5. 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 this, 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...”<sup>113</sup>

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.<sup>114</sup>

#### **Box J. 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 paying to municipalities 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)<sup>115</sup>

##### **Tightening procedures**

Gaborone City Council in Botswana had no clear procedure for following up 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)<sup>116</sup>

## Section IV: Paying for public spending: borrowing and debt

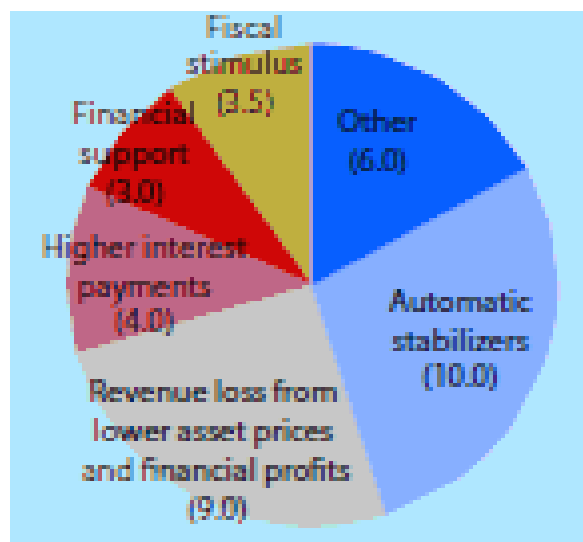
### 10. Government deficit and debt

Public spending by governments has been the key mechanism for dealing with the recession. 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 T. 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.<sup>117</sup>

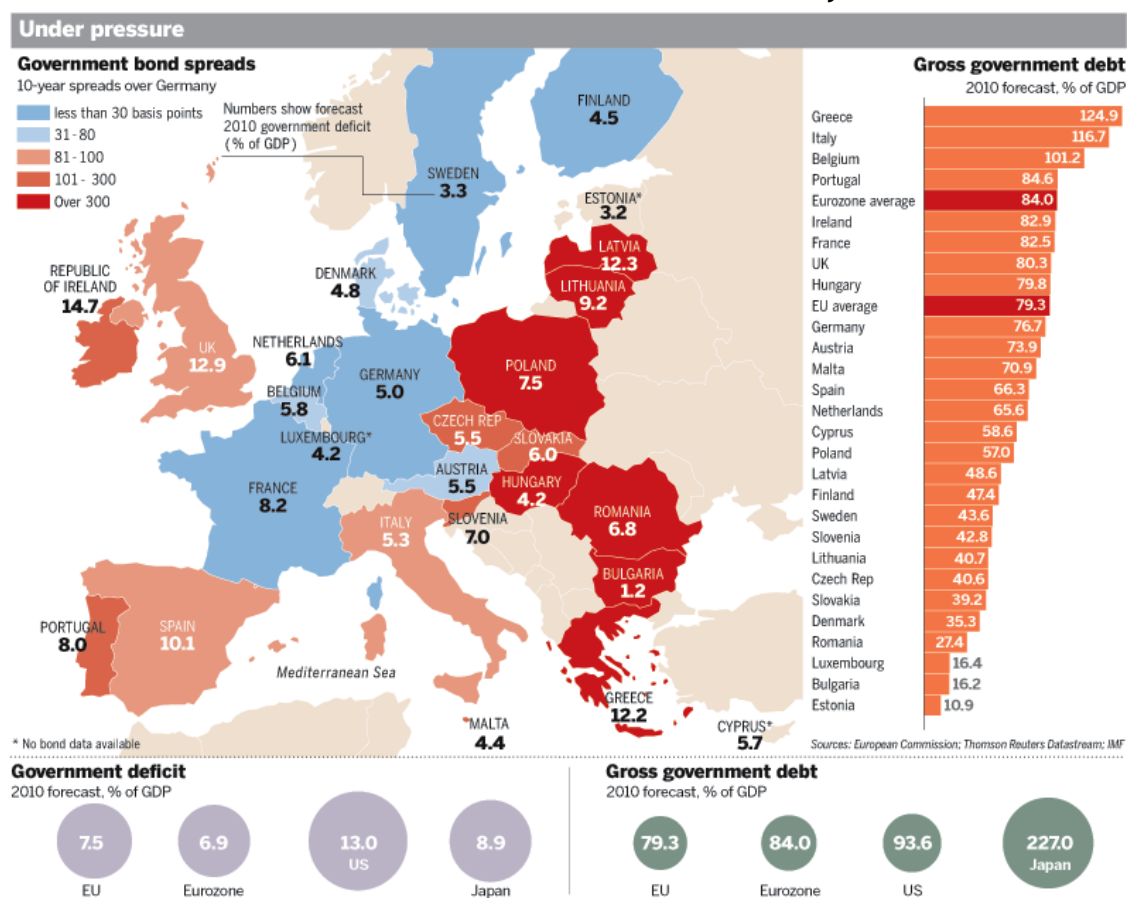


As can be seen in chart V there is a wide range of existing debt and deficit levels – but other factors are more important in deciding what countries have to pay for their borrowing. In 2009 Japan had debt worth 200% of GDP, while Estonia, Bulgaria and Romania all had debt levels of less than 30% of 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:

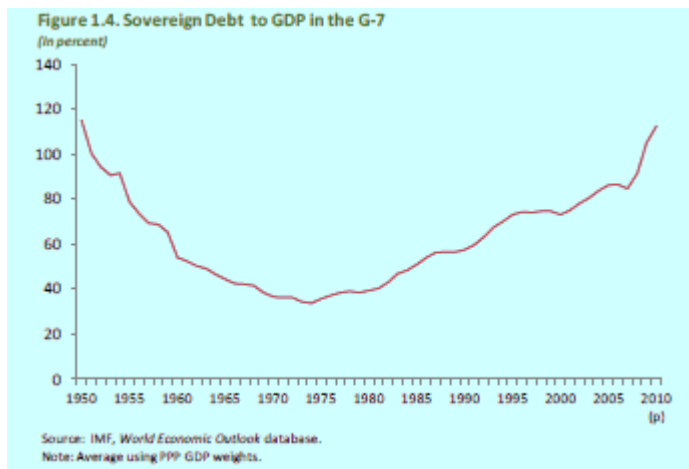
The rescue of the financial system, unprecedented monetary easing and fiscal expansion (most of the latter being automatic rather than discretionary) have indeed put a floor under the world economy ... Now suppose that, instead of keeping calm, the authorities are frightened into premature monetary and 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 ...<sup>118</sup>

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



Source: [Financial Times February 9 2010 'Investor headwinds lash Euro solidarity'](#), by Ralph Atkins in Frankfurt and Chris Giles in London



**Chart V. 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>

## 11. Private sector finance

### 11.1. Selling state and municipal companies

Many governments have raised large sums of money by selling all or some of the shares in state-owned operations. Some municipalities, too, have raised money by selling shares in municipal companies. The proceeds are used to pay off debts, reduce taxes, or invest in other services. About USD \$1,800 billion has been raised in this way over the last 30 years.

But the apparent gains are illusory.

Firstly, the money received from the sale is not a gift, but a payment in exchange for a real asset, the company, and its future income. So the government – or municipality – lose all the assets of the company, and any dividends or income they would have got from it. Zambia was told by the IMF to privatise all its municipal housing and water services in the 1990s, but the municipalities lost the income from rents and water charges which they had used to finance other services, and council rates were harder to collect from the private tenants.

Secondly, industries are often sold for less than their true value, in order to encourage buyers. The UK electricity companies were sold for only a third of their asset value, the water companies for only about 4% of their replacement value. So the new owners gain at the government's expense. And governments may continue to subsidise companies after privatisation – for example, railway operators or electricity distributors may get subsidies to keep fares and charges down.

Thirdly, consumers pay higher charges after privatisation than they would do otherwise. This is partly because of the higher cost of private capital (see section 11.2) – English water users pay about £1 billion per year more than they would need to under public ownership. And it is partly because companies will always exploit a monopoly: water prices in France are 15% higher under private companies than in systems run by municipalities, after taking other factors into account.

### 11.2. Creative accounting with PPPs

Public–private partnerships (PPPs) are also used as a way of raising money for expensive infrastructure projects through the private sector, to avoid any increase in public borrowing. The private partner in the PPP raises the money, so the government does not have to – and the bridge, or tunnel, or motorway, or railway, or school or hospital – still gets built.

This seems like a wonderful trick, but it is just that – a trick. There is only room here for a summary of the many problems with PPPs – they are covered in detail in other reports by PSIRU and others (see section 11.3).

The first fundamental problem is the illusion that PPPs bring in private money to pay for the infrastructure, so the state can spend its money on something else. But the opposite is true. The great majority of PPPs rely on a stream of income from payments by government (for the hospital, school, railway, etc.) – i.e. public spending (with the exception of true concessions, where the private company makes all the investment “at its own risk”, expecting to get the necessary income from payments made by consumers (e.g. water charges or road tolls). As the European Commission puts it, PPPs include “important safeguards for private investors, in particular the stability of long term cash-flows from public finances”. PPPs do not supplement public spending – they absorb it.<sup>119</sup>

The second problem is that infrastructure projects require a lot of capital – but governments can always borrow more cheaply than companies, so raising money through PPPs is always the worse option. This has been stated very clearly by the IMF, surprisingly: “... private sector borrowing generally costs more than government borrowing ... This being the case, when PPPs result in private borrowing being substituted for government borrowing, financing costs will in most cases rise ...”.<sup>120</sup> And PPPs do not mean that the government no longer has to pay the interest – it still has to do this but by paying the private company for its

more expensive finance. Even governments of developing countries can borrow money as cheaply as multinationals for investments in infrastructure in their own countries, because multinational shareholders will not guarantee projects in developing countries. Credit ratings for electricity projects in the Philippines financed by the largest multinationals in the world (EdF, Shell, Bechtel) were given ratings no better than the government of the Philippines.

The financial crisis has made this problem even worse, because it is now very difficult for any private companies to raise finance except at very high interest rates – making PPPs prohibitively expensive, even for their greatest supporters. By mid-2009 companies had to pay interest rates about 4% higher than governments, and although the gap has varied since then, it remains too large for PPPs to have any credibility.<sup>121</sup>

The third problem is that PPPs have to make up for their more expensive capital by being more efficient in operations. It is often assumed that PPPs will result in greater levels of efficiency, just because of the private partner. But the empirical evidence does not support the assumption that there is any systematic difference in efficiency between public and private sector companies.

A global review by the World Bank in 2005 concluded: “For utilities, it seems that in general ownership often does not matter as much as sometimes argued”.<sup>122</sup> Studies of the UK privatisations have concluded that there is “little evidence that privatisation has caused a significant improvement in performance”.<sup>123</sup> Even in telecoms, a sector where the private sector is assumed to be performing better than the public sector could, a global study comparing private and public companies found that there was indeed “efficiency growth following privatizations” – but “it is significantly *smaller* than growth in public sectors.”<sup>124</sup>

Finally, when PPPs are used to finance public investment, the private investors naturally seek to protect themselves against risks and uncertainty. Governments therefore usually provide some form of guarantee, or agreement to carry risks, to provide greater security for the private investor. In order to deal with these problems, governments often guarantee the loans made to the private partner, or guarantee to buy output e.g. of a power station for 30 years. But, as the IMF again notes: “... resort[ing] to guarantees to secure private financing can expose the government to hidden and often higher costs than traditional public financing”. For example, in the 1970s and 1980s in Spain, the government had to pay \$2.7 billion compensation to private toll road investors because of exchange-rate guarantees it had given. Pakistan, India and Indonesia were forced to pay \$260 million to compensate private companies involved in independent power producers (IPPs) which had gone wrong, because they had government guarantees to buy the output at prices guaranteeing a profit.

The extra irony is that, since the financial crisis, state banks and institutions are actually lending money to PPPs, in order to borrow it back from them. The International Finance Corporation (IFC) finances PPPs; northern countries are now using aid money to fund private equity investments in PPP projects in the south; and the public sector development banks such as the European Investment Bank (EIB) and European Bank for Reconstruction and Development (EBRD) are doing the same. The UK, France, India and other countries have set up special funds to lend to PPPs which private banks will not lend money to.

The many PPPs established under the UK’s private finance initiative (PFI) are already assured of long-term payments from the government for 20, 30 or 40 year contracts. The chart below shows how these payments will peak in 2030, at £2billion – about 1.5% of UK GDP. Because this is contractually fixed, it becomes impossible to cut, so it ‘crowds out’ other possible spending.

Finally, many PPPs fail to live up to their financial and operational promises. There are many examples from around the world, but the most starkly shocking are the two London underground railway PPPs, known as Metronet and Tubelines. Both of these have now collapsed, and the work has been taken back in house. The UK parliamentary committee delivered a scathing report on the collapse of Metronet, reproduced below as a warning to the rest of the world.

Despite all this evidence, governments and international institutions continue to try to develop PPPs, as a way of reconciling the needs of infrastructure-building with the artificial constraints imposed on public finance. The European Commission has recently published a report encouraging all EU countries to

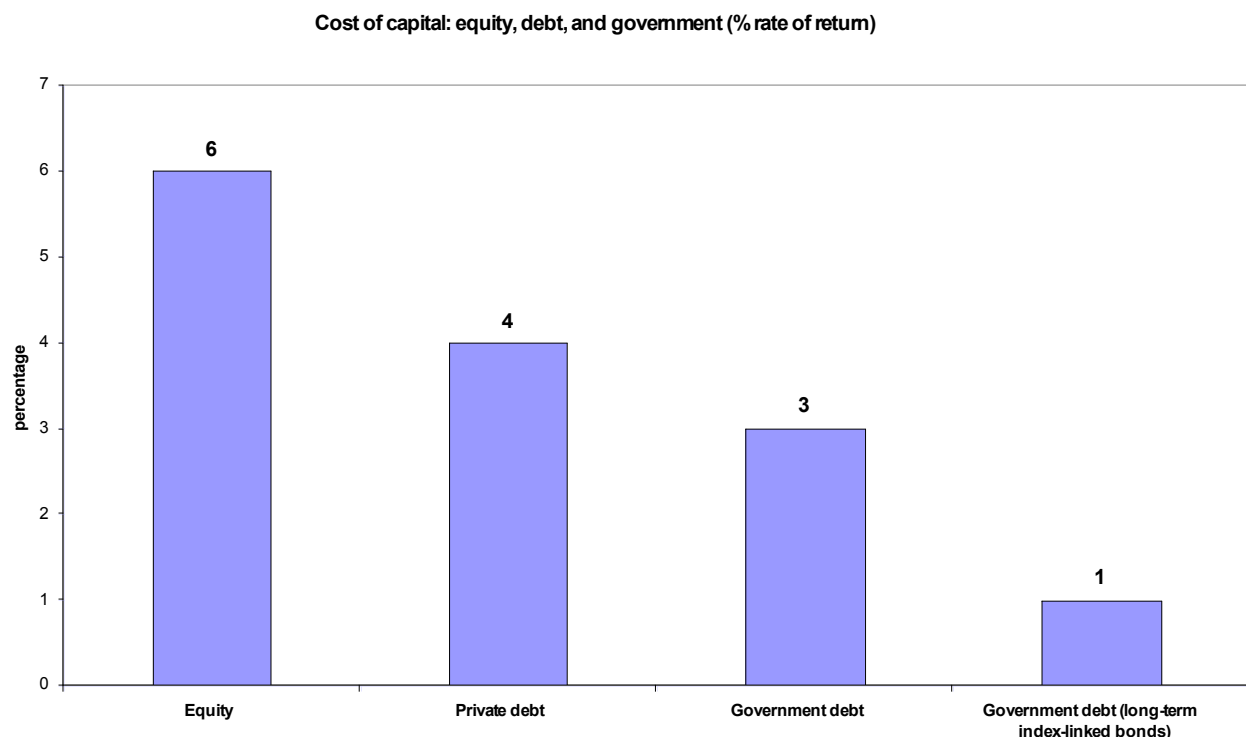
introduce as many PPPs as possible. In November 2009, the UN economic commission for Europe organised a meeting in Geneva to try to combine global and national institutions into a wider international pressure group to support PPPs, asking for donations and subscriptions.<sup>125</sup> This initiative emerged following an international conference on PPPs in May 2009, involving the World Bank, ADB, UNECE and various Asian governments, which was presented with a lucidly expressed argument that PPPs were becoming dysfunctional and discredited because of the crisis:

Discontent, even outright hostility, among the general public against the capitalist system has gained ground during the crisis ... The 'system' is mistrusted, and confidence in capitalism and its future is low ... The crisis appears to have had its roots in the era of deregulation and is replaced by the growing role of the state in managing financial capitalism and exercising accountability previously absent in the system; ... PPPs are equated with the now discredited privatisation and financial liberalisation.<sup>126</sup>

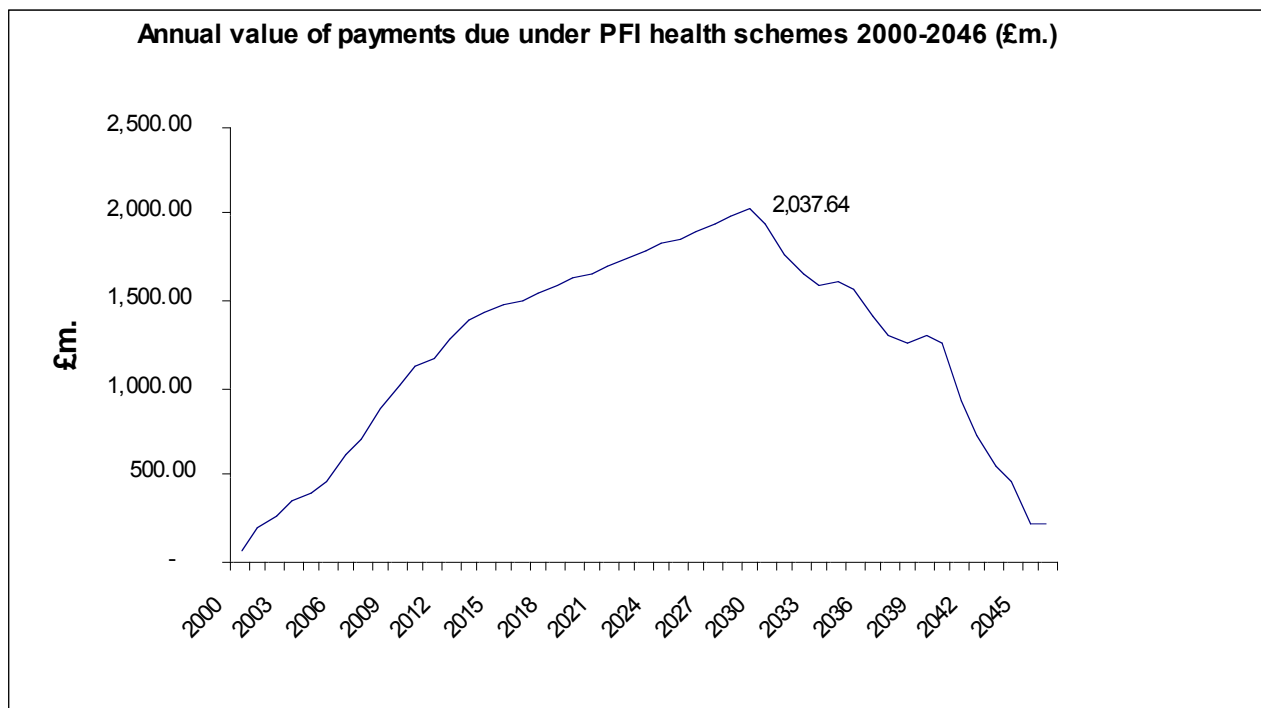
This accurate assessment was followed by a simple political call for a global campaign in favour of PPPs: there was a need for "tools to bring back the banks and new institutions able to articulate a pro-PPP policy in the crisis (and those in the future) ... a global advocate to spread support and the message around the globe: an alliance of PPP units."<sup>127</sup>

Thus, the international financial institutions and national finance ministries – all public sector institutions sustained by public finance – combine to act as an international lobby group to protect PPPs and discourage a revival of direct public sector financing and provision of infrastructure.

**Chart W. Relative cost of capital (UK)**



Source: OFWAT, Helm 2006, PSIRU calculations<sup>128</sup>

**Chart X. Expenditure on PFI schemes in the UK's national health service (NHS)**

Source: calculated from Treasury PFI projects list<sup>129</sup>

#### **Box K. The summary case of Metronet: learning from a failure**

The collapse of the London underground Metronet PPP cost the UK's public finances between £170million and £410million.<sup>130</sup> Metronet represented one-sixth of the total value of PFI schemes in the UK. These extracts from the conclusions of the parliamentary report should be noted not only in the UK but elsewhere.<sup>131</sup> (The second PPP, Tube Lines, was also terminated in 2010).

“The return anticipated by Metronet's shareholders appears to have been out of all proportion to the level of risk associated with the contract. The parent companies were effectively able to limit their liability to the £70 million they each invested in Metronet at the outset. ... In the face of this very limited liability it is difficult to lend any credence to the assertion that the Metronet PPP contracts were effective in transferring risk from the public to the private sector. In fact, the reverse is the case. Metronet's shareholders, had the company been operated effectively, stood to make quite extravagant returns. Now that it has failed, it is the taxpayer and the Tube passengers who must meet the cost.

“In terms of borrowing, the Metronet contract did nothing more than secure loans, 95% of which were in any case underwritten by the public purse, at an inflated cost – the worst of both possible worlds ... If finance cannot be secured at reasonable terms without guaranteeing the vast majority of the debt, loans direct to the Government, which would enjoy the highest credit rating and significantly lower costs, would seem to be the more cost-effective option.

“Metronet's inability to operate efficiently or economically proves that the private sector can fail to deliver on a spectacular scale, although Tube Lines' performance provides an example of private sector innovation and efficiency. The evidence is clear: it cannot be taken as given that private sector involvement in public projects will necessarily deliver innovation and efficiency, least of all if the contracts lack appropriate commercial incentives. Future assessments of the comparative value for money of private sector-managed models for infrastructure projects should not assume a substantial efficiency-savings factor;

“We recommend that the Government, as a matter of urgency, make a full assessment of the additional costs that have been incurred as a result of the failure of Metronet – including the cost of work that has been inefficiently undertaken and the cost of administration.

“The Government should not enter into any further PPP agreements without a comprehensive and accurate assessment of the level of risk transfer to the private sector and a firm idea of what would constitute an appropriate price for taking on such a level of risk. If it is not possible in reality to transfer a significant proportion of the risk away from the public purse, a simpler – and potentially cheaper – public sector management model should seriously be considered.

“The Government should bear the Metronet debacle in mind if and when its parent companies – Atkins, Balfour Beatty, Bombardier, EDF Energy, Thames Water – next come to bid for publicly funded work.

“The Government should remember the failure of Metronet before it considers entering into any similar arrangement again. It should remember that the private sector will never wittingly expose itself to substantial risk without ensuring that it is proportionally, if not generously rewarded. Ultimately, the taxpayer pays the price.

“Whether or not the Metronet failure was primarily the fault of the particular companies involved, we are inclined to the view that the model itself was flawed and probably inferior to traditional public-sector management. We can be more confident in this conclusion now that the potential for inefficiency and failure in the private sector has been so clearly demonstrated. In comparison, whatever the potential inefficiencies of the public sector, proper public scrutiny and the opportunity of meaningful control is likely to provide superior value for money. Crucially, it also offers protection from catastrophic failure. It is worth remembering that when private companies fail to deliver on large public projects they can walk away—the taxpayer is inevitably forced to pick up the pieces.”

### 11.3. Creative accounting and counter-taxation

Governments and international institutions have used PPPs as an ‘approved’ way of maintaining infrastructure investment within fiscal rules. This implies that the optimum level of public expenditure is higher than would otherwise be permitted by these rules: the rules are adjusted to permit investment through PPPs as additional to that allowed under fiscal limits (and indeed further adjusted to legitimise some of the financial rescue mechanisms as permitted ‘additional’ spending). They achieve this effect in the same way as Enron, the USA energy multinational which collapsed in the early 2000s, by moving debts ‘off-balance sheet’, so it looked as though they did not exist.

PPPs also resemble innovative financing mechanisms, such as credit default swaps, in at least three respects. Firstly, the main incentive for public authorities to adopt them is as a way of getting around fiscal rules. Countries such as Greece, and many municipalities, used debt swaps in order to reduce the apparent level of debt, in order to avoid breaching fiscal debt limits imposed by the EU or national governments; similarly, the greatest incentive for using PPPs is to reduce the apparent level of debt and deficits. Secondly, the promoters of these instruments insist that there is very little risk associated with them – but the impact has in many cases been disastrous for public finances and public services. Thirdly, remarkably, the European Commission is actively encouraging governments to use these innovative financial instruments – and to use PPPs – at the same time as pretending to enforce limits on government deficits.

The problem with PPPs is that they create long-term contractual rights to public spending (and thus, indirectly, to tax revenue). They are, in effect, a form of ‘counter-taxation’ by private companies on the state. They need to be avoided and reduced, to free up tax revenues for better uses – including delivering the same infrastructure for less cost.

For more details on PPPs see:

- *More public rescues for more private finance failures*, March 2010 <http://www.psiru.org/reports/2010-03-PPPs.doc>
- *Public-private partnerships (PPPs) in the EU – a critical appraisal* November 2008 <http://www.psiru.org/reports/2008-11-PPPs-crit.doc>
- *Protecting workers in PPPs* October 2008 <http://www.psiru.org/reports/2008-11-PPPs-workers.doc>
- *Alternatives to PPPs: positive action for in-house services* October 2008 <http://www.psiru.org/reports/2008-11-PPPs-altern.doc>

## Section V: Conclusion: The politics of public spending

This report has reviewed the economic and social role of public spending, and the role of taxation and borrowing in financing such spending. In the wake of the financial and economic crisis, there are strong pressures being exerted to reduce the role of public finance and the public sector, even at the expense of higher unemployment and economic recession. These issues are being contested in a political process, because public spending decisions are political, not a consequence of market interactions.

The actors in this process include the International Monetary Fund (IMF) and other international bodies such as the G20 and the European Union, as well as some governments. Their agenda is being resisted through democratic political processes. This final section looks at the IMF agenda, some examples of resistance and support for the use of public finance, and finally considers factors affecting the outcome.

Two international institutions – the IMF and the EU – have been arguing strongly for ‘exit strategies’ to unwind the stimulus packages. These strategies have been driven not so much by the desirability of reducing public deficits as on the need to avoid increases in public spending. Even before the crisis, both institutions believed that public spending was already rising too fast, and most of all that demographic changes were going to increase public spending even more, throughout northern countries.

The IMF thinks that the impact of the crisis on government spending and borrowing is much less important than the impact of the ageing populations of the north: “In spite of the large fiscal costs of the crisis, the major threat to long-term fiscal solvency is still represented, at least in advanced countries, by unfavourable demographic trends ... These increases have come on top of an already rising spending trend, in real per capita terms and also relative to GDP, during this decade”.<sup>132</sup> When the EU council of ministers issued an economic policy statement in May 2009, it focused almost entirely on the demographic impact on public spending, but barely mentioned the economic crisis.<sup>133</sup>

Thus the IMF says of the rescue and stimulus packages that, coupled with the fall in tax revenues, they have increased deficits in high-income countries by on average 7.5% of GDP. The demographic changes are expected to lead to increases in spending of a further 4–5% of GDP in high-income countries. The IMF then claims that these increases must be avoided by general ‘adjustments’ in public finances equivalent *on average* in high-income countries to a cut of 8.7% of GDP by 2030. To give some perspective on the scale of this demand, it is the equivalent of halving the procurement spending of such countries, or halving the number of public employees.

**Table 21. Effects of crisis on public spending and IMF targets for reducing spending**

	Primary public expenditure as % of GDP, 2007	Annual real growth 2008–2010: Primary public expenditure	Annual real growth 2008–2010: GDP	Average adjustment called for by 2030 by IMF
High-income countries	35.8	4.30%	-0.20%	-8.70%
Developing countries	24.5	9.30%	5.10%	-2.75%

Source: IMF 2010<sup>134</sup>

The IMF proposes policy measures which are based overwhelmingly on spending cuts. In healthcare, it is concerned only with reductions in *public* spending (despite the clear evidence that public healthcare is both more efficient, and more effective, and more economically beneficial, than private spending). It says:

... bold reforms are needed to offset the projected rise in age-related outlays, particularly health care. In pensions, a further increase in statutory retirement ages of two years could offset the projected rise of spending of 1 percentage point of GDP over the next 20 years in advanced economies. In health, the challenge is greater, and has so far been underestimated, particularly in Europe. New staff projections show that health spending could rise by 3½ percentage points of GDP over the next 20



years in advanced countries. Reforms are needed to address supply-side incentives, limit public benefits, or reduce the demand for public health services. But while many countries have managed to reform significantly their pension systems, the difficulty of health reform is underscored by the dearth of prominent reforms in advanced countries aimed primarily at reducing spending.<sup>135</sup>

In all other public spending, the IMF calls for, as a target, a reversal of the growth in public spending as a proportion of GDP, through a 10 year freeze, and specifically encourages a freeze on the wages bill:

In other spending areas, in addition to allowing stimulus spending increases to expire, a possible policy goal could be to freeze spending in real per capita terms for 10 years. This would save 3–3½ percentage points of GDP. It would require deep spending reforms. Containing the wage bill has in the past proved to be key to successful fiscal consolidation.

The European Commission more simply continues insisting on the existing limits on public deficits (3% of GDP) and public debt (60% of GDP). The consequences of this are already apparent across Europe, with cuts in spending, services and jobs, and wage freezes and cuts for public employees.

#### **Box L. Ageing population: no spending cuts necessary?**

By contrast, some of the arguments that are used for cutting spending on public services may not stand up to examination. One example is the spectre of the ‘demographic timebomb’, which is used to claim that other social spending has to be cut back to finance the growing cost of supporting a greater proportion of old people.

But this is not a new argument. In the 1950s, opponents of the welfare state in the UK claimed that the growing number of pensioners meant it would lead to unaffordable costs in future years. In fact: “in the quarter-century or so after the second world war ... the number of pensioners increased so much that ... they probably accounted for about 10% of the increase in total social welfare expenditures alone since the Second World War”.<sup>136</sup> But economic growth allowed the spending to be met and also for other services to grow.

Similarly, the IMF arguments now depend on assumptions: a study published by the IMF itself notes that “alternative assumptions ... lead to vastly different conclusions about fiscal sustainability.” Making realistic assumptions about growth rates, growth would be enough to support the age-related expenditures and still allow growth in non-age-related public spending in 18 of 19 countries studied.<sup>137</sup>

One part of the argument on pensions is that economies cannot afford to pay for pensions out of taxation, so pensions should be paid for out of profits from investments. But the pensions are paid out of national income either way – through profits if they are funded, through general taxation on all income if they are ‘pay-as-you-go’. The pensions would only become more ‘affordable’ to the national economy if they are reduced in value.

The demographic picture is also incomplete: although the number of people working will have to support an increasing number of retired dependents, they will be supporting a lower proportion of dependent children, and so the overall ratio of dependents to working people in the USA, for example, will remain below the levels in the 1960s.<sup>138</sup>

On the other hand, these pressures are already being resisted, especially – as the IMF complains – over healthcare. The most remarkable resistance has been the campaigns against commercialisation of public health services in the four central European countries – Czech Republic, Hungary, Poland and Slovakia – since around 2006. In each country there were proposals to introduce some combination of patient fees, commercialisation or privatisation of hospitals and clinics, and a switch from state insurance to private insurance funds. In each country there has been vigorous public resistance which has succeeded in halting or reversing or limiting these plans.

Slovakia was the first country to introduce the reforms, but has now abandoned them. In 2003, user fees were introduced; two years later, health insurance funds and hospitals were converted into commercial entities, helped by the state paying off their debts of €1.1 billion Euros.<sup>139</sup> But following widespread public opposition, a new government was elected in 2006, which abolished user fees. Since then, Slovak health policy has continued to move against the neo-liberal style of reforms, by insisting that health insurers must be non-profit and by explicitly rejecting any privatisation.<sup>140</sup>

The Czech health-care system is “remarkably efficient” Only 6.8% of the country’s total gross domestic product was spent on healthcare in 2006, one of the lowest levels for OECD countries. The health of the population has improved rapidly in the past 20 years: life expectancies increased by 5.4 years for men and 4.6 years for women, compared with average increases of 4.4 and 3.2 years, respectively, in richer countries. The infant mortality rate is 3.14 deaths per 1000 live births – well below the EU average and among the lowest in the world.<sup>141</sup> Despite this, the then government introduced patient fees in January 2008, and proposed policies which would privatise the health insurance system, and convert teaching hospitals into commercial companies. There was strong public opposition, led by a civil society movement, the Coalition for Health, which included a general strike in June 2008 involving nearly 1 million workers, and demands from patients’ associations and others for abolition of fees and renationalisation of insurance into a single state fund. A court case trying to get the fees ruled unconstitutional failed, but the government lost all the regional elections in October 2008, with a record turnout of 40% of voters. The new regional governments then decided not to charge fees to patients in regional healthcare facilities and pharmacies; the government sought a court ruling that this was unconstitutional. Inconclusive elections in May 2010 resulted in a continued centre-right coalition.

In 2006 the Hungarian government proposed health service reforms which included hospital closures, the introduction of fees, and the privatisation of health finance by the creation of regional, part private, insurance funds. The parliament passed a first law to introduce patient fees, and fees for other public services, including university education. Campaigns gained enough signatures to force two referenda in 2008. The first resulted in a large majority against the fees; the government abandoned the plans for private insurance companies without waiting for a certain referendum defeat. In 2009, Hospinvest, a private company in which the European Bank for Reconstruction and Development (EBRD) took an equity stake of 30%, and which had already secured contracts to run nine state hospitals and clinics, filed for bankruptcy.<sup>142</sup>

In Poland, proposals to commercialise and privatise hospitals were introduced by the government at the start of 2008. The plans also included a list of medical procedures that the state will pay for, and those which patients would have to pay for. They met with strong resistance from the public, with doctors, unions and others combining to reject the plans as tantamount to privatisation. The private healthcare sector in Poland is seen as an oligopoly with a bad reputation: “... clients of private health centres or hospital complain more and more often about the quality of services”. The president of Poland also objected to the proposals, and at the end of 2008 he vetoed the legislation and called for a referendum, saying that he “would not allow for the privatization of the health care system ... Human health and life is not a commodity.”<sup>143</sup>

The outcomes of these and other contests will remain.

- Global public spending will grow because of growth and economic development in middle and lower income countries. The annual growth rate for developing countries in the near future is expected to be around 6% on average, much faster than high-income countries. In addition, this process will lead – following Wagner’s law – to public spending accounting for a higher percentage of GDP as well, for example through large-scale investments in infrastructure, so this will further drive up the global figure.
- The need to deal with climate change alone will add about 1.5% of GDP to public spending levels, globally. This figure will remain for decades.
- The increased needs of elderly northern populations for pensions and healthcare are estimated by the IMF as an extra 4.5% of GDP. This figure will decline again as the populations change once more, but the demographic developments may replace this factor with other demands.

- The economic crisis is far from over, and even northern governments which wish to cut public deficits and spending may find – as did Germany’s Angela Merkel after her re-election in 2009 – that economic realities require deficits to be maintained to avoid large-scale unemployment.

The combination of these factors suggests that cuts anywhere near the IMF’s target are quite unrealistic. But it will still require major political activity in many countries to insist that public spending should be determined by democratic decisions according to what is economically and socially and environmentally best.

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### 13. Notes

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<sup>17</sup> This estimate is based on (a) \$410billion for developing countries (Nellis, 2006) <http://www.maxwell.syr.edu/moynihan/programs/euc/Nellis%20Priv%20Dev%20Cos.pdf>; (b) \$ trillion (\$1,000 billion) for OECD countries, as estimated by Bortolotti and Pinotti 2008 'Delayed Privatisation' [http://www.bancaditalia.it/pubblicazioni/econo/temidi/td08/td663\\_08/en\\_td663/en\\_tema\\_663.pdf](http://www.bancaditalia.it/pubblicazioni/econo/temidi/td08/td663_08/en_td663/en_tema_663.pdf). This latter estimate is coherent with the data in the Privatisation Barometer database <http://www.privatizationbarometer.net/database.php>, showing total revenues from European privatisations of about \$880billion by 2008; (c) estimates by Megginson of \$1,500billion by 2005 (*The Financial Economics of Privatisation* 2005 p.21); (d) Megginson's figure is taken as the core estimate with which the others are broadly consistent. It has then been increased by an assumption of a further £300billion worth of privatisations since 2005, as indicated the reports of Privatisation Barometer (PB) 2008 [http://www.privatizationbarometer.net/PUB/NL/3/7/PB\\_AR2008.pdf](http://www.privatizationbarometer.net/PUB/NL/3/7/PB_AR2008.pdf); (e) PB 2008 makes a similar assessment of the relative impact of the support for the financial sector and the cumulative total of privatisations: "governments worldwide acquired more assets from the private sector [in 2008] – probably exceeding \$1.5trillion in bank stocks and loans – than they divested to investors through privatization programs. This figure is impressive, especially considering that global privatization revenues from 1977 to date are worth the same amount."

<sup>18</sup> (A) upfront support: IMF, see table 3, above; (B) privatisation revenues: based on Megginson (2005), Nellis (2006), Bortolotti and Pinotti (2008) and Privatisation Barometer 2008. This estimate is at the upper end of estimates of global privatisation revenue. (A) \$1 trillion (\$1,000 billion) for OECD countries, as estimated by Bortolotti and Pinotti 2008 'Delayed Privatisation' [http://www.bancaditalia.it/pubblicazioni/econo/temidi/td08/td663\\_08/en\\_td663/en\\_tema\\_663.pdf](http://www.bancaditalia.it/pubblicazioni/econo/temidi/td08/td663_08/en_td663/en_tema_663.pdf). This is consistent with the data in the Privatisation Barometer database <http://www.privatizationbarometer.net/database.php> showing total revenues from European privatisations alone of about \$880billion. by 2008. To this can be added \$410bn. for developing countries (Nellis, 2006, <http://www.maxwell.syr.edu/moynihan/programs/euc/Nellis%20Priv%20Dev%20Cos.pdf>; (B) estimates by Megginson of \$1,500billion by 2005. (*The Financial Economics of Privatisation* 2005 p.21). Megginson's figure can be increased by a further \$300 billion worth of privatisations since 2005, as indicated the reports of Privatisation Barometer (PB) 2008 [http://www.privatizationbarometer.net/PUB/NL/3/7/PB\\_AR2008.pdf](http://www.privatizationbarometer.net/PUB/NL/3/7/PB_AR2008.pdf); (C) PB 2008 makes a similar assessment of the relative size of the support for the financial sector and the cumulative total of privatisations: "governments worldwide acquired more assets from the private sector [in 2008] – probably exceeding \$1.5 trillion in bank stocks and loans – than they divested to investors through privatization programs. This figure is impressive, especially considering that global privatization revenues from 1977 to date are worth the same amount."

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Indirect jobs: using BERR estimate of 1.2million jobs supported by £79billion spending, implying a jobs:spending ratio

of about half compared with direct labour (5.2million jobs from £160billion spending), and assuming that the ratio of

non-service procurement (£67million) is half of that again, so the overall employment effect of 8% of GDP spent on

procurement (the OECD estimate 2008) is to support just over one-third of the jobs that would have been supported as

direct labour; employment effect of construction spending taken from Scotstat, implying a higher ratio of about two-

thirds the effect of direct employment; public utilities, using an average of the CEEP figure 6% and the implied ILO

figures of 4% and 2%. Multipliers for direct labour, construction and utilities are weighted averages of Scotstat

multipliers for the relevant sectors, including induced effects: see

<http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Input-Output/IOAllFiles2004> ; for procurement, the

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