Fiscal Policy in the Future: Challenges and Opportunities*

by

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I. Introduction

Modern tax systems developed largely in the period between 1930 and 1960 when there were: (a) major restrictions on trade erected during the Great Depression and World War II; (b) limited capital movements; (c) little cross-country investment; (d) little international mobility of people; and (e) almost no cross-country shopping by individuals. During these decades, governments had not yet assumed many of the social and economic responsibilities that they assumed in recent decades. Tax burdens were generally under 30 percent of the industrial countries' gross domestic products (GDP) until around 1960.

Between 1930 and 1960 two important "technological" innovations were introduced in the tax area. These were: (a) the introduction and the affirmation of the "global and progressive" income tax and (b) the introduction of the value added tax. These two developments, together with social security taxes on the growing shares of wages and salaries in national income, would contribute a great deal to the rise of tax levels which, in later years, in many OECD countries, exceeded 40 percent of GDP and even 50 percent in a few countries. Of course, some forms of income had been taxed before this period in various countries. For example, wages, presumptive profits, or rents from properties (inputed or not) had been taxed separately, with low and often proportional rates, for a long time. This "schedular approach" to income taxation had been popular in some of the continental countries of Europe.

In a book published in 1938 that became influential, Henry Simons, a professor at the University of Chicago, made a strong case for taxing all sources of income of individuals as a whole (the so-called global income) and for taxing this total with highly progressive rates. Some German economists had made similar recommendations. It was argued that this approach would better satisfy revenue and equity considerations at a time when disincentive efforts of high marginal tax rates did not receive much attention. Coming during the Great Depression and soon after the U.S. New Deal (and just before World War II) this tax became popular in the United States and helped finance the Second World War. In the U.S. it came to be seen as the fairest of all taxes. Given the American influence in the world after World War Two the concept was exported to other countries. After the war and for two decades, American tax consultants were active in trying hard to promote this tax in developing countries and in the 1940s American advisers to Germany and Japan tried to push it in those countries.

The value added tax originated in France and was, thus, a European innovation. It replaced the turnover (cascade) taxes on transactions, taxes that had been common in many European countries, including the six members of the Coal and Steel Trade Community. It was welcomed by the members of that Community, because it allowed the zero-rating of exports and the imposition of imports, without discord between trading partners. The countries were free to impose the VAT tax rate they liked or needed, presumably without interfering with foreign trade flows. This feature made the value added tax a useful instrument in countries that were part of customs unions. The value added tax has proven itself to be a major revenue source for all countries. See Tanzi (2006).

In industrial countries, the two developments mentioned above, together with the taxes on labor income levied to finance public pensions (the so called "social security contributions"), made it possible for the tax systems of many countries to finance the large demands for public revenue that the growing functions of government, especially in the so-called welfare states, were creating. See Tanzi and Schuknecht (2000).

II. The Growing Role of Globalization

In recent decades, and especially since the 1980s, important developments have been changing the economic landscape that had characterized earlier decades. These developments have potentially great implications for tax systems and for expenditure policies. The most important among these developments are:

(a) The opening of economies and the extraordinary growth of international trade. The world economy has become much more integrated than in the past.

(b) The phenomenal increase in cross-border capital movements. This increase has been promoted by the removal of obstacles to capital mobility facilitated by new policies and by technological innovations that have made communication cheap and rapid. There has been an extraordinary growth in the amount of capital that now crosses frontiers on a daily basis. This capital finances direct investment, feeds portfolio investments, covers current accounts imbalances, and provides needed foreign currency to international travelers.

(c) The importance of multinationals has grown enormously both in the financing of direct investment or in promoting trade among parts of the same enterprises located in different countries. Time is long past since most enterprises produced and sold their output in the same country or even in the same region where they were located. Trade among related parts of the same enterprises, located in different countries, has become a large and growing share of total world trade.

(d) These international activities, accompanied by higher per capita incomes, falling costs of transportation, increased informational flow, and policy changes have led to a high mobility of individuals, either in their role as economic agents or as consumers. A large and increasing number of individuals now earn all or parts of their incomes outside the countries where they have their official residence. Also a large and increasing number of individuals spend part of their income outside the countries where they officially live. Thus, markets are more and more global.

The implications of these developments for the countries' tax systems and for the economic role of the nation states are not fully understood by policymakers or economists. However, there is increasing evidence to suggest that the developments described above are creating growing difficulties for the tax administrators of some countries and opportunities for those of others. They are also raising questions about the optimal role of the state in current globalized economies. We shall first deal with the tax implications and then with implications for the optimal role of the state.

Because of the developments described above, a country's <u>potential</u> tax base is now no longer strictly limited by that country's territory, but, in some sense, it has extended to include parts of the rest of the world. A country can now try to <u>attract and tax fully or partly</u>: (a) foreign financial capital; (b) foreign direct investment; (c) foreign consumers; (d) foreign workers; and (e) foreign individuals with high incomes, including pensioners. These possibilities are fueling 'tax competition' among countries. Tax competition implies that, to some extent, a country's tax burden can be exported. A country, and especially a small country, may now be able to "raid" the tax bases of other countries in a way that was not possible in earlier times. Like the ocean and the atmosphere, the "world tax base," is becoming a kind of "commons," a common resource that all countries can try to exploit to their advantage and to the detriment of other countries.

Tax competition is in part related to the importance of taxation for location. By lowering the burden of taxes, on some sensitive activities, tax competition aims at making particular locations (say Ireland or Luxembourg or Lichenstein) more attractive to some investors and for particular activities than other locations. The attraction of a location depends on several elements such as: (a) nominal or statutory tax rates; (b) tax practice (administrative and compliance costs); (c) predictability of the tax system, or "tax certainty" over time; (d) legal transparency, that is clarity of the tax laws; (e) use of tax revenue, that is the services that the residents <u>or the enterprises</u> get from the government in exchange for the taxes paid; (f) fiscal deficits and public debt, because these may forecast tax increases in the future; and more generally, (g) the economic or investment climate of the country which is much influenced by regulations, rule of law and similar factors. Of course some of these elements are more important for permanent residents than for occasional investors.

Ceteris paribus, low tax rates can attract business activities and financial capital, or even consumers or pensioners, to a particular location by making it more attractive to them from a tax point of view. However, the ceteris paribus assumption often does not hold. Other elements may neutralize a low tax level. For example, the predictability of the tax system and compliance costs are important elements. In some countries uncertainly and lack of transparency have become very important elements but they are often important for citizens but less so for occasional portfolio investors or visitors. The "tax climate" of a particular location can influence: (a) the amount of investment in that location and the choice of investment; (b) how that investment will be financed; and (c) the legal form that the enterprises will choose.

When people face high tax rates, or an unfriendly tax climate in today's environment, they may: (a) "vote with their feet," thus moving to a friendlier tax environment as long as the ceteris paribus condition holds; (b) "vote with their portfolio," by sending their financial assets abroad, to safer and lower taxes jurisdictions; (c) remain in the country, but exploit more fully tax avoidance opportunities, and (d) engage in, or increase, explicit tax evasion. Globalization and tax competition are making it easier to exploit these options.

Tax competition is creating frictions and diplomatic problems between specific countries and between groups of countries. Leading newspapers, often report stories on it. It has been a hot topic: (a) within the European Union; (b) between some countries of the Union and Switzerland; (c) between the European Union and the United States; (d) between China on one side and Europe and the United States on the other; (e) between the Caribbean counties and OECD countries; and so on.

A relevant question is whether tax competition is ultimately a positive or a negative global development. Should policymakers welcome it or not? On this question views diverge sharply. Some theoretical economists and economists with a public choice bent, tend to see it as a beneficial phenomenon. Ministers of finance, directors of taxation and policy-oriented economists tend to see it as a problem. Ministers of Finance of France, Germany, Italy and other countries have at times been sharply critical of this phenomenon.

The arguments in favor of tax competition are the following:

(a) It forces countries to lower their high tax rates especially on mobile tax bases, such as financial capital, highly skilled workers, and so on.

(b) By reducing total tax revenue, tax competition forces governments to reduce inefficient public spending. This “starve the beast” theory was promoted by Milton Friedman and became popular during the Reagan Administration.

(c) It allocates world savings toward areas where, it is claimed, the savings are used more productively.

(d) Because of lower tax revenue, it forces policymakers to re-think the economic role of the state, to make it more focused and efficient.

(e) It leads to a tax structure that is more dependents on immobile tax bases which economic theory considers less distortional for the economy.

Against these arguments in support of tax competition, there are others that find it damaging. The main ones are the following.

(a) Because public spending may be politically or legally inflexible downward, especially in the short run, tax competition can lead to increased fiscal deficits, high public debts, and macroeconomic instability.

(b) When governments are forced to cut public spending by tax competition, there is no assurance that they will cut the inefficient part of public spending. Inefficient spending may have strong political constituencies that protect it compared to more productive and efficient spending.

(c) Tax competition may lead to “tax degradation”. Government may try to maintain public revenue by introducing bad taxes to replace lost revenues.

(d) The shift of the tax burden from mobile factors (such as financial assets and highly skilled individuals) to immobile factors (largely labor income) will make the tax system less fair.

(e) The increased taxes on labor income are likely to stimulate the growth of the underground economy and of tax evasion.

(f) Tax competition (and reactions to it) could make tax administration and tax compliance more costly and difficult. Growing complexity is a frequent consequence of tax competition.

It is still difficult to identify the quantitative impact of globalization on tax revenue. But closer observation can identify some impact and point to growing future difficulties:

(a) In OECD countries, the ratio of taxes to GDP stopped growing in the 1990s, even though large fiscal deficits called for higher tax revenue. In an increasing number of OECD countries, the average tax ratio started to fall in the most recent years.

(b) The rates of both personal income taxes and corporate income taxes have been reduced substantially in most countries, in part because of tax competition.

(c) The rates of excise taxes on luxury products have been sharply reduced in most countries in the past two decades leading to substantial falls in revenue from these taxes. These reductions are in part the consequence of the increased foreign travel by taxpayers and the possibilities that it offers for shopping in places where excise taxes on expensive and easy to carry items are lowest.

(d) The "global income tax," has been losing popularity. There has been a progressive return to schedular income taxes. The <u>dual income taxes</u> introduced by the Scandinavian countries and by some other countries are an example of the losing attraction of global income taxes.

(e) There is a growing interest in flat rate-taxes and in "consumption-based taxes."

III. The Rise of Fiscal Termites

In some papers written over the past decade, I discussed the rise of what I called "fiscal termites." These "termites" result from the interplay of globalization, tax competition and new technologies. Like their biological counterparts, fiscal termites can weaken the foundations of the current tax systems making it progressively more difficult for countries to maintain high levels of taxation. I will list only some of these termites without much elaboration. For more elaboration see Tanzi (2001).

The first of these termites is Electronic Commerce. Electronic commerce has been growing at a fast rate both within countries and among countries. It has been growing for consumer goods and services, as well as for trade in inputs of intermediate and capital goods. Its growth has been accompanied and facilitated by the growing shift, in the countries' gross domestic products, from physical to digital products. This kind of commerce leaves fewer traces than the previous invoice-based commerce and is much more difficult to tax. Electronic commerce is creating great difficulties for tax administrators and legislators who seem to be at a loss on how to deal with it.

A second termite is Electronic Money (credit cards, other forms). Real money is progressively being replaced by electronic money embedded in chips of electronic cards. A "purse" software may be purchased through deposits in foreign banks or from secret bank accounts making it more difficult to trace and tax various transactions.

A third important termite originates in transactions that take place between different parts of the same multinational enterprises (i.e., intra-company transactions). Because these transactions are internal to a company, they require the use of "transfer prices" that is of prices at which one part of the enterprise, located in a given country, "buys" products or services form other parts of the same company located in other countries. These different parts of a multinational company are located in countries with different tax systems and tax rates.

Furthermore, the products or services bought and sold, especially when they are inputs, may not be traded in the open market. Therefore, there may not exist market or "arm's length" prices that can be used as references. Problems arise especially (a) with inputs that are made specifically for a final product (say a particular jet plane); (b) with use of copyrights, trademarks and patents for which a value must be determined; (c) with the allocation of headquarters R & D or other fixed costs; (d) with interest on loans made from one part to another part of a multinational corporation for which a determination of a market rate is difficult. The determination of these costs or of the prices of the goods and services traded within the enterprises is often difficulty and arbitrary. It lends itself to manipulations by enterprises aimed at showing more profits in those countries (such as Ireland), where taxes on enterprise profits are low, and less profit in countries where the taxes on enterprises are high. The strategic use of "transfer prices' by enterprises can significantly reduce the total taxes paid by multinational enterprises. It has been a major problem for tax administrators.

Another termite is the existence and continued rapid growth of <u>off-shore financial centers and tax havens</u>. Total deposits in these tax havens have been estimated to be huge. The distinguishing characteristics of these tax havens are: (a) low tax rates, to attract foreign financial capital; (b) rules that make it difficult or impossible to identify the owners of the deposits in these countries; (no name accounts, banking secrecy, etc); and (c) lack of regulatory powers, and of information on those deposits, on the part of the countries where the real owners of the deposits reside. These tax havens allow individuals and enterprises from the countries where the capital originates to receive incomes that are difficult for national authorities to tax.

Still another termite consists of new, exotic and complex financial instruments that are continually entering the financial market. The day is long past when a normal citizen could understand, and easily choose from, the financial instruments in which he/she invested savings. New financial instruments, such as various categories of derivatives, are far more complex. They are designed by extremely clever and highly paid individuals. Many of these new instruments are specifically designed to avoid (if not evade) paying taxes. As a consequence, it is more and more difficult for the employees of tax administrations, who have a normal training and modest salaries, to keep up with these developments.

Increasing foreign activities of individuals, both as workers and as consumers, are also creating difficulties for national tax administrations. Incomes earned abroad are often not reported to the national or home country tax authorities. Foreign travel allows individuals to buy expensive items (jewelry, cameras, etc.) in countries where excise taxes are lower. Competition for mobile consumers has encouraged some, especially small, countries to intentionally lower these excise taxes in order to attract foreign buyers. Compared to decades ago many airports have become huge shopping centers. Because of these trends many countries are facing growing difficulties to raise the high tax revenue that they could raise in the past. Time is not likely to change these trends.

In addition to the "termites" mentioned above, there are other developments that could merit to be added to the above list. Furthermore, some of the above termites are likely to combine or mutate thus creating even greater difficulties.

The developments described above over the years, will have a progressively larger impact on: (a) tax revenue; (b) tax structures; and (c) the use of particular tax bases. Thus reducing the policymakers' degrees of freedom. The net result will be a world with lower tax revenue and <u>different</u> tax systems. It would be wise for governments to acknowledge these developments and begin to take the necessary compensating actions. These actions will inevitably concern the spending side of public activity.

IV. The Growth of Public Spending

The last half century has witnessed major developments in the economies of the industrial countries and in the role that governments have played through public spending. This section describes some of these developments and attempts to pierce the veil of the role that governments might play in the future.

The tax levels of many industrial countries are today close to their historical high. In 1870, advanced countries had public spending and tax levels of about 13 percent of GDP. The United States had even lower levels. The economic role of the state at that time was limited and focused on "core" functions. These were: defense, protection of individuals and property, administration, justice, and large public works. These core functions were largely those described in 1776 by Adam Smith in his book, The Wealth of Nations.

In the past century public attitudes vis-à-vis the economic role of the state started changing and governments were pressured to widen their economic role. The pressures led to the phenomenal expansion of the economic role of the state that took place especially in the second half of the 20^{th} century. Public spending started to grow during World War One but grew slowly until about 1960. The great acceleration came in the period between 1960 and 1990 when many countries, and especially the European countries, created mature welfare states that aimed at the economic protection of individuals "from the cradle to the grave". In several European countries including Germany, public spending approached or even exceeded 50 percent of GDP.

There is some debate on whether the large increase in public spending, as distinguished from the growth in per capita income over the period, contributed to a genuine improvement in the welfare of the majority of citizens, or whether the citizens would have been better off with a lower growth in that spending that would have left them with more money in their pockets but less governmental services. Greater public spending often went towards paying for social services, such as – health and education or for cash transfers to pensioners, the unemployed and others. Because public sector intervention often displaces existing charitable or non profit institutions or private intervention, it does not necessarily or automatically add, on a net basis, to the informal arrangements for social protection that the citizens were receiving or could have received through private programmes. For example, in some countries there had been extensive networks that informally provided some social protection to those in needs.

It can be assumed that the welfare of citizens is linked to the numerical results of certain socio-economic indicators--such as life expectancy, infant mortality, educational achievements, literacy rates, growth in per capita incomes, inflation and others--that governments want to influence through their public spending. Evidence collected by Ludger Schuknecht and I has shown that there has been little relationships, if any, in recent decades between changes in the countries' shares of public spending in GDP and changes (in the desired direction) of these socio-economic indicators. Countries that allowed their public spending to grow significantly more than other countries (the "large government" countries) do not show, on the average, better quantitative results for these indicators than countries that kept their governments smaller and leaner.

The higher taxes needed to finance high public spending reduce the disposable income of taxpayers, thus restricting their economic freedom. Most likely, over the long run, they also have a negative impact on the efficiency of an economy and on economic growth. An obvious question is whether the level of public spending (and consequently, of taxation) should be reduced <u>if this could be done without reducing public welfare</u>. That is to say, if public welfare is not reduced, on any objective criterion, by reduced public spending, then public spending and tax revenue could be cut. This would allow most individuals to have discretion over a larger share of their pre-tax incomes. In other words the citizens would decide how to spend this money, not the government.

The theoretical reasons advanced by economists to justify the role of the state in the economy, including the need to assist the poor, could be satisfied with a much smaller share of spending in GDP than is now found in most industrial countries if the government could be more efficient and focused in the use of their tax revenue. Much public spending "benefits" the middle classes broadly defined. At the same time much of the "burden", imposed by the government in the form of taxes, falls also on the middle classes. Putting it differently, the government taxes the middle classes with one hand and subsidizes them with the other, playing the part of a classic intermediary. As a consequence of this "fiscal churning", the government creates disincentives and inefficiencies on the side of taxation as well as on the side of spending.

It is not likely that governments need to spend more than, say, around 30 percent of their GDPs to be able to promote and finance their fundamental social and economic objectives. Some well-functioning countries do not allocate more than 20 per cent of their GDP, for public programs. Even among the highly developed countries, some (United States, Switzerland, Australia and Ireland) have public spending levels not too far from 30 per cent. And in some of them, there is even scope for spending reduction. Two of these countries (United States and Australia) have some of the highest scores on the Human Development Index the index provided by the UNDP. Switzerland is also likely to have a high score.

The real difficulties that would be faced by a government in reducing the role of the state in the economy is not that a less dominant state would imply a reduction in economic welfare but, rather, that a reduction in public spending would face strong political opposition on the part of those whose current or expected standards of living have come to depend on the existing public programmes. Fears of such opposition has tied the hands of European policymakers. Public programmes inevitably create strong constituencies: pensioners, those close to the retirement age, school teachers, public employees, those who receive public subsidies, and others. These constituencies consider a reduction in public spending as a negative-sum game. Therefore, the evidence that some countries with relatively low levels of public spending operate well cannot be interpreted as an indication that high-spending countries could easily and painlessly reduce their public spending. It only means that after the short run costs of reform have been paid, a country could continue to have high socio-economic indicators (high social welfare) with significantly lower public spending and more individual liberty.

Levels of public spending at any one time tend to be set by past political trends and promises, rather than by informed decisions based on the evidence of the day. Annual budgets are typically incremental. They rarely address the question whether an activity should be continued. At any given moment the level of public spending depends substantially on the entitlements and claims on the government created in past periods. It does not depend on well thought-out analyses and considerations of what the state could or should do in a modern and more sophisticated market economy. It rarely matches the spending level that the government in power might wish to have if it had the freedom and courage to change the status quo.

For the reasons mentioned above, there is often no realistic possibility of a genuine zero-base assessment of the optimal economic role of the state at a given moment in time. However, if past mistakes, or misguided actions, have determined the current level of public spending, that level cannot be assumed to be optimal or nearly optimal in an economic or even political sense. It is simply the result of political opportunism. It is, thus, important to distinguish, at least analytically, what could be the optimal role of the state in the long run from its current role.

Should the governments of today simply accept the status quo? Or, should they have the courage to put in motion radical reforms that in the long run – say over a generation – would bring the role of the state more closely in line with an ideal or currently economically optimal role? Recent experiences in several European countries, including Germany, France and Italy, indicate that the second alternative is a politically difficult one because of powerful political opposition to real reform. However, the alternative has not been well articulated and well presented by the political forces in power. At the same time some countries, such as Canada, Ireland, Finland and others, have initiated a process that could lead to a more limited and efficient role of the state.

Another way of putting the question is: what economic role should the state play, especially in relation to public spending, in advanced industrial countries in the 21st Century? This is a difficult question to answer because, inevitably, the answer to it must reflect political biases as well as the importance that one attaches to the transitional costs of getting from where we are today to where we could to be, say, 20 or 30 years from now. The greater the importance that one attaches to the transitional costs, and especially to the political costs, the greater will be the inclination by policymakers to maintain the status quo and the current spending programs. It is natural that governments want to remain in power rather than risk reforms that demand much political capital. Let me focus on some essential elements to consider when dealing with the above question.

The first of these elements is the recognition that in a market economy there should be a relationship between what the market is capable of doing and what the government should do. After all, in a market economy, the state is supposed to correct the mistakes made by the market, or to compensate for its shortcomings, and not to replace the market. More efficient markets should require less government. In a society where the market is underdeveloped for a variety of reasons, so that it is not capable of performing well some important tasks – be these to provide necessary goods and services; to create jobs for most of those who wish to work; to create efficient insurance markets that could allow individuals who wished to do so to protect themselves directly against various economic risks; to provide efficient and relatively safe channels for investing savings needed during later or during retirement years, and so on – there will be a presumption for the state to step in, thus correcting or complementing the market in some of these functions. This was the main argument that, over the years, led to the enormous expansion in the economic role of the state especially in the last half century.

In this connection it should be mentioned that the School of Public Choice would questions the need for governmental intervention even under circumstances in which the market is deficient. Those who adhere to this school believe that governmental intervention, to correct shortcomings of the market often makes things worse rather than better. This may happen because a country in which the private market, is not developed is not likely to have a public sector that is efficient. The same factors that make for an underdeveloped private market are likely to make for an inefficient public sector. Public Choice followers argue that, when the government intervenes, market shortcomings are often replaced by governmental shortcomings. One could add that the search for an optimum may be futile in the real world so that we should accepts economies where some deficiencies continue to exist. Utopia does not do well in real world circumstances.

As markets develop and become potentially more efficient in performing various tasks and in allowing individuals to satisfy various needs directly and not through the intermediation of the government, -- including the need to buy protection against particular events that could have economic consequences-- the theoretical justification for governmental intervention through public spending decreases. This should result in a fall in public spending. A perfect market, if it existed, would, of course dispense with the need to have any government at all. However, a perfect market cannot exist. Furthermore some government role is needed to make or keep the market as efficient as it can be.

A second important element is that when in past decades the government entered a given sector, it introduced laws and regulations that facilitated and justified its own intervention in that sector. This inevitably made it more difficult or at times impossible, for the private sector to develop private alternatives in that sector. Governmental involvement created public monopolies that eliminated the possibility of private alternatives. Public monopolies in energy, communication, postal services, transportation, the provision of pensions, health services, education and in several other activities, in many European countries, prevented the market from developing potentially efficient private alternatives to the public programs in these areas. This created the belief, on the part of a large sector of the public, that the public sector must remain engaged in these areas if the welfare of citizens is to be protected. For this reason in European countries many citizens have or would oppose reforms that once made, would benefit them and the majority. Of course particular groups would suffer short run losses so that their lobbies would be strongly opposed to reforms.

A third element is that rapid technological innovations, the growing sophistication of the market on a global scale, the development of global financial services, and globalization in general are changing the conditions for providing needed services for citizens.

The current role of the state was developed mostly in the period after World War II, when, for a variety of reasons, the markets of many countries were far less developed than they are or can be today and far more closed. This was the period when the concept of a "mixed economy", that assigned a large economic function to the state, seemed natural and was most popular. At the time it must have seemed natural for governments to take over many new responsibilities and in fact the economic profession generally encouraged them to do so.

In spite of many obstacles imposed by governments, and the existence of many public monopolies, markets have become much more sophisticated over the years. With the right governmental guidance they could become even more sophisticated. Various developments have made it possible for the private sector to replace activities that had been previously public. Technological developments have destroyed the presumption that there are "natural monopolies" in the generation of electricity, in various forms of transportation (railroads, airlines), in communications (telephones, telegraphs), in postal services, and in other areas. This presumption, widely accepted half century ago, had assigned to the public sector major or exclusive responsibility in these areas. In several countries, the government has started to withdraw from some of these activities and relatively well functioning private markets have quickly developed in them. This is certainly the case also for private pensions, financial services, and transportation and communication. In most cases the economic welfare of the citizens has not been damaged by these developments. On the contrary, and with exceptions that often are much publicized, services have often improved in quality while prices have fallen significantly.

Major developments in financial markets, including greater international capital mobility, have removed the presumption that financial savings must be invested domestically and that governments should be involved in the allocation of private savings and credit. In financial markets as well as in the other areas mentioned above, there is, however, a very important surveillance and regulatory function that governments must perform. This function cannot, or should not, be left to the private sector. It is a function that should be taken seriously by the government but that so far it has not been. It should be part of the core activities of the state.

A fourth element is that globalization, in its various aspects, is bringing major changes to the way markets operate or could operate. Foreign competition can make domestic markets more efficient by destroying or reducing the power of domestic private monopolies and by offering alternatives. Globalization is affecting and can affect public sector activities in other ways. By eliminating frontiers, or making them less constraining, globalization is creating the potential for more options for both citizens and governments. For example, educational and health services can now be obtained more easily than in the past in other countries. In some sense they have become tradable goods. Public sector procurement can now benefit from foreign participation, thus reducing government costs. Savings can be invested abroad. This access to foreign markets has created options beside the ones traditionally available domestically and which were often available only from the public sector.

V. Looking at the Future

The current role of the state in many European countries is likely to prove unsustainable in future decades because of the impact of demographic development on public spending and of globalization on government revenue.

Demographic developments with unchanged policies, will push up dramatically various public expenditures and especially those for health, pensions, and the care for the very old. This increase in spending will come on top of already precarious public finances and high tax and public debt levels.

The impact of globalization on government revenue and tax competition was discussed earlier. It will be difficult or impossible for many European countries to compete with China, India, Vietnam, Mexico and various other countries while maintaining tax levels that are already high and not capable of financing even today's public expenditure. The impact of the baby boom on social spending is yet to come and the impact of globalization and tax competition on tax revenue has just started to make itself felt. In the next ten years both could be in full force. To prevent major future fiscal difficulties there is only one way out: to try patiently, systematically, and rationally to scale down the spending role of the state in the economy while making a serious and competent effort to increase the efficiency of the private as well as that of the public sector. This would make it possible for the private sector to step in and replace the government role in covering some important economic risks that citizens face thus allowing the public sector to reduce its spending.

The reduction in the spending role of the state should be based on three pillars. The first pillar should be the improvement in the working of the private market through the effective use of the government's regulatory power. In this role the government will need to be ruthless and efficient. It must be realized that in a market economy this is surely the most important role of the state. The only objective of the regulatory role should be to make the private market as efficient as possible by destroying legal or implicit monopolies and eliminating positional rents. The government must introduce competition in areas where it has not existed or has been limited in the past. It must force private enterprises and institutions to become transparent and honest in the data and the information that they publish. It must remove abuses whenever they exist. The more successful is the government in this action, the easier it will be to transfer successfully part of the role that the government has played in the economy in past years to the market.

The new government role in protecting individuals against rights with economic consequences can be played in two ways. First, by requiring individuals to buy some minimum protection directly from the market. Governments already force individuals to: (a) get insurance for their cars; (b) get driving licenses: (c) have fire alarms in their buildings; (d) build safe buildings; (e) wear seat belts; (f) quit smoking in public places; (g) get vaccination against some diseases; and (h) take other actions aimed at making individuals pay for or avoid being damaged by events that might affect them as well as others. Why not apply the same principle vis à vis the treatment for major illness, minimum pensions, or other similar needs?

Second, by providing to the truly poor the financial means that would allow them to buy from the market a basic package of insurance against particular risks or basic services. This approach would require less universal and more targeted public assistance to the citizens. This is an alternative course of action to the one that requires the government to step in, with universal spending programs, when, presumably, there is market failure. The alternative suggested is obviously a politically and administratively demanding one.

The second pillar should be the progressive substitution of programs with universal, free or almost free access, toward more targeted programs for the poor based exclusively on ascertained and documented needs. Universal programs (such as free health services for all, free higher education for all, etc.) are easier politically but are expensive. Targeted programs can save a lot of money but they are more demanding politically and in terms of information. Also problems connected with poverty traps must receive specific attention. The difficulties in these changes cannot be minimized.

The third pillar should be the progressive exploitation of new opportunities offered by globalization for services not domestically available or available at high costs – such as elaborated medical procedures, advanced technical training, relatively safe channels for money saved for old age, and so on. These can now be bought from foreign providers if the domestic private market is unable to provide these services at competitive prices and the government has still the obligation to provide these services to some citizens.

It is obvious that much thinking and much experimentation will be required over the next years or even decades to bring out the progressive and efficient scaling down of public spending and tax levels. It is also inevitable that mistakes will be made. But when it comes--and it will come unless the world repeats the mistake of the 1930s when it entered a long period when markets, that had been open, closed--the transformation is likely to include the three pillars mentioned above. Without that transformation, the public finances of several European countries will become more and more a public concern.

Background Material

The speech is based on several previous publications by the author. For elaborations of some of the points made, the following publications should be consulted:

1. "Globalization, Tax Competition and the Future of Tax systems," in Steuersysteme der Zukunft, edited by Gerald Krause-Junk (Berlin: dunker and Humblot, 1998).

2. "Globalization, Technological Developments and the Work of Fiscal Termites," Brooklyn Journal of International Law, Vol. XXVI, No. 4, 2001.

3. "Globalization and the Future of Social Protection," Scottish Journal of Political Economy, Vol. 49, No. 1, February 2001.

4. "The Economic Role of the State in the 21st Century," The Cato Journal, Vol. 25, No. 3 (Fall 2005).

5. "Making Policy Under Efficiency Pressures; Globalization, Public spending, and social Welfare," in The New Public Finance, edited by Inge Kaul and Pedro Concicao, Oxford University Press, 2006.

6. Death of an Illusion? Decline and Fall of High Tax Economies, London: Politeia, 2006.

7. Public Spending in the 20th Century
Cambridge University Press: 2000 (With Ludger Schuknecht).