The Economic Role of the State Before and After the Current Crisis *

by

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I. Introduction

Perhaps there is no more fundamental question in economics than the economic role that the state, or less precisely the government, ought to play in a democratic country with a market economy. This question has become particularly significant at this time because of the financial and economic crisis that is affecting the world, and that is calling for a reevaluation of the activities of governments. Historical developments and statistical evidence indicate that such a role is not fixed in time, for the same countries, and in place, across different countries. Furthermore there is little agreement on what that role ought to be and every crisis raises new questions on it. The Great Depression created similar pressures on governments to change their roles and led to some changes.

Economists have developed various theories about what the state should do in the economic sphere. So-called "normative theories", that became popular half a century ago, start from the assumption that there are natural "market failures" that need to be corrected by the government to enhance economic welfare. See, especially, Musgrave, 1959 and Bator, 1960. If markets worked "perfectly", there would be no need for an <u>economic</u> role for the state even though the state would still exist to play important political and social functions and it might be called to play a redistributive funciton. However, for a variety of reasons, markets do not work perfectly or even efficiently. These normative theories assume that the intervention by the state is benevolent and efficient. The policymakers who act on behalf of the state, in all its aspects, have no personal interests to promote but have only the public interest in mind. Furthermore, they have the skill and the knowledge to intervene successfully.

These theories, based on market failure, are, for the most part, tied with the function of the state in the allocation of resources. They stress the existence of "public goods", "natural monopolies", "externalities" and other factors, including "asymmetric information", that make private markets "fail" and call for the intervention of the government to correct for these failures. These failures are seen as illnesses and the government as the honest and knowledgeable doctor capable of curing them. Technological progress may eliminate some of these "natural" failures and increasing complexity in the economy may create other kinds of failures. Some of these market failures, are at any one time, natural. Some, however, could be eliminated or reduced if the state played a forceful and efficient role in its regulatory function. Recent developments in the financial and other markets have highlighted the importance that an efficient regulatory function of the state might have had in preventing the developments that led to the current economic crisis. Some believe that the crisis could have been avoided, or at least reduced in intensity, if governments had prevented abuses or excessive exposure to risks in the financial markets.

Seventy (70) years ago Keynesian economics, an outcome of the Great Depression, added another important theoretical reason for an occasional governmental intervention. Counter cyclical, or stabilization, policy can be justified, in particular circumstances, on grounds of a special kind of market failure, the failure of the market to maintain an adequate aggregate demand capable of producing stable economic development with full employment. In the 1970s and later years, Keynesian policies came under sharp attacks by leading economists, some winners of Nobel prizes for their criticisms of it. However, Keynesian policies remained popular among policymakers and among many economists. Their popularity has grown at this time.

Economic theory has been ambiguous, in its many contributions, about the precise role that the government should play in reducing income inequality and, more broadly, in protecting citizens against particular risks which have economic consequences. Even a perfectly working market may generate an income distribution that is too uneven for some communities. It should be realized that income distribution and protection against risks with economic consequences are two different objectives. Protection against some of these risks was assumed to be made difficult by particular types of market failure thus encouraging governments to take over some markets. See, for example, Pauly, 1974. There are no widely accepted theories related to these aspects. However, much of the action of governments in recent decades has been justified on grounds that (a) it would make the distribution of income less uneven and (2) would protect citizens against various economic risks. These have been the important factors contributing to the growth of public spending oven the years. Pure public goods have attracted a lot of academic attention but have contributed little to the growth of public spending.

II. The Role of the State in the 20th Century

If governments had based their economic policies on the widely shared theoretical justifications advanced by economists over the past half century, the role of the state (at least the one played through the traditional instruments of taxing and public spending) would have been much smaller than it became in most countries. Clearly other forces promoting a larger role. Economists may have an inflated opinion o the impact that they have on the political decisions that determine economic policies. However, at best they just influence them. The decisions are made by policymakers who, often, do not have much economic background and who, inevitably, are influenced by the views and the requests of those who

elect them or can help them stay in power. These requests originate from the personal interests of groups of voters who may in turn be influenced by their economic literacy. In some countries the citizens tend to see the government as the solution to most problems, even problems over which governments have little real influence. In others, or at times in the same countries, citizens tend to see the governments as the cause of many problems.

The role of the state in the economy changed enormously during the past century. It is reasonable to expect that it will continue to change significantly over the 21st century. How much of an impact the ongoing financial and economic crisis will have remains to be seen. But, for some countries, it will surely have an impact. The key question is how the role of the state will change. Will it continue the trend toward higher government spending and taxing, as witnessed over the past century? Or will the direction change toward a different role? Will it continue to rely mostly on the budgetary instruments? Or will it rely more on other, non-budgetary instruments of economic policy, including regulations? No magic ball is available to provide us with an answer. All we can do is speculate.

In order to forecast the future, it is often worthwhile to study the past because it past can offer potentially useful lessons. There is now a general tendency on the part of the public to take for granted the current role that governments play and to consider it as normal or even too limited. Most of the pressures on governments are to expand that role. However, the 20th century started with an economic role that, by today's standards, was almost incredibly small. It ended the century with one in which the state was playing an enormous spending role, in countries that continued to claim to be market economies.

Public spending as a share of gross domestic product (GDP) grew in many advanced countries, from about ten percent of GDP, at the beginning of the 20th century, to around 50

percent of GDP at the end. See Tanzi and Schuknecht, 2000. In developing countries it grew less mainly because of their difficulties in raising revenue. A large part of this growth occurred in the decades after World War Two. After 1950 the share of public spending (and of taxes) into GDP grew at a record pace. See also Nutter, 1978. By the end of the 20th century, in several countries, a significant proportion of the population was getting a large share of disposable incomes from the government while losing a large share of earned income to the government in higher taxes. This was the liberal "social contract" that some economists wrote about. See Kolm, 1985

The growth of public spending during the 20th century was caused mainly by the spending responsibilities that governments assumed in many countries in the provision of public pensions, public or publicly financed health services, public and compulsory education for an increasing number of years of schooling, public housing, assistance to large families, subsidies to (inefficient) public enterprises, assistance to the unemployed, to the very old, to the handicapped, and so on. These programs had at best a very indirect connection with the public goods that were seen as the main justification for governmental intervention. Incidentally, the list is much longer than the main categories indicate. Government programs often run into the thousands making it difficult to get a full understanding of the governments' actions. Public spending for most of there activities had been inexistent at the beginning of the 20th century. In many of these activities the state replaced the market, or private, civic activities that had existed earlier. It claimed that, in so doing, it was promoting the public interest. There was definitely a kind of "mission creep" character to this governmental expansion. See Tanzi, 2005; and Wuthnow, 1991.

Citizens who depended on these government programs, or on government jobs, came to see the government's new role as normal and beneficial. A form of "fiscal illusion" (see Puviani, 1973) helped create the belief in them that this expanded government role was efficient and necessary and that, without it, most citizens would be worse off. Some of these government programs came to be identified with civil rights that had created legal entitlements as almost new forms of property rights on the part of the citizens against the community. Because of fiscal illusion, citizens tended to see the benefits from the public spending more easily than the costs associated with the financing of the programs that provided the benefits. Especially when the government provided free services, these services were seen as bargains by many citizens. Behavioral economics has shown how difficult it is for people to resist the allure of things or services offered for free, even when these "free things" involve real and significant, but not transparent, costs. See Ariely, Chapter 3, 2008. Many prominent economists applauded the expanded government role. For example, Tony Atkinson has described to growth of the government role into welfare states as "one of the most successful social innovations of recent centuries? See Atkinson, p. 22. And Assar Lindbech has described the modern welfare state as "a triumph of western civilization, 1995, p. 9.

In promoting this expanded role, governments needed much larger financial resources than in the past. These resources were obtained mainly, but not only, from taxes, with some help from public borrowing. The tax systems were reformed by the introduction of new taxes – such as global and progressive income taxes, value added taxes, and social securities taxes – and, occasionally, by the more intensive exploitation of older taxes. The increasing share of wages and salaries in national income, that was taking place until the

later part of the 20th century, made the increase in tax revenue from income taxes administratively easier. The left-leaning intellectual winds that prevailed until the late 1970s facilitated this expanded government role.

The new spending programs had often the declared objective of reducing some economic risks faced by citizens. Risks with economic consequences were illiteracy, limited education and training, debilitating illnesses, old age, invalidity, unemployment, having too many children, and so on. The expanded government role was believed to reduce these economic risks below the levels they would have reached without that intervention. Thus, it was seen as clearly beneficial. Some of these risks were given official quantification even though in reality it was difficult to quantify them. For example, at what age is one too old to work? At what degree of physical handicap one becomes officially invalid, so as no longer be able to work? Once these standards were set, there was pressure to reduce them. Effective retirement ages came down while life expectancy was increasing (see Gruber and Wise, 1999) and a lot of people became "officially" invalid even though they were in conditions that would allow them to work. They had expanded their de facto property rights (i.e. claims) against society.

III. Assumptions Behind the Growth of the Economic Role of the State

At least two fundamental assumptions accompanied, or justified, the larger intervention of the state although these assumptions were generally not spelled out. First, and perhaps more importantly, was the view that citizens are myopic. Left to their own, they would not, individually or collectively, but privately, take the actions needed to protect themselves or their families against the economic risks. Only the government could do it. They would not save for their old age or would not invest wisely; would not send their

children to (private) schools; would not ensure themselves against, or accumulate assets to pay for, occasional illnesses, and so on. Second, even if they had wanted to do so, the private market or various private associations (including charitable or non-profit ones), would not have been capable of satisfying the citizens' needs. Failures in the market made this option difficult.[1] Free riding on the part of individuals combined with adverse selection and "cream skimming" on the part of enterprises, and moral hazard made the market less efficient than desired. These assumptions were used to promote and justify a paternalistic and growing spending role for the state.

In the phenomenal expansion of public spending that took place between the first and the second half of the 20th century, the state became a huge insurance company and an enormous intermediary between the public sector and the citizens. In this "social contract" the citizens paid fees in the form of high taxes and were repaid by the state with generally free or highly subsidized public services in addition to government jobs for some of them. The connection between the taxes paid (the tax prices) and the public services received was not fully understood by many citizens, creating the illusion on their part that they were receiving "free" government services. In the United States some citizens had the opposite illusion: that they were receiving no services at all for the taxes paid.

The connection between taxes paid and services received applied to the whole citizenry and not to specific citizens. For specific citizens the connection was often not close. Some gained or lost much more than others in this forced "social contract" they were part of. For example, citizens that, because of good habits, were healthy or did not have children ended up subsidizing those who were less healthy and those who had several

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[1] For some issues related to shortcomings in the market for annuitization for private pension arrangements see Diamond, 2004.

children. This happened even when not being healthy was partly the result of free choices -- such as smoking, drinking, being not exercising and being obese -- and; and having more children was clearly a voluntary choice.

In a classic example of free riding, some citizens learned to “game and manipulate” the system to their advantage by (a) evading taxes; (b) going underground in their economic activities; (c) faking illnesses so that they could get paid vacation; (d) claiming invalidity when they were in condition to work; (e) doing little in their government jobs; and (f) generally shifting a greater cost of financing the welfare state toward the honest, hardworking and those who, because of their economic situations (being dependent workers in large private firms), were less able to abuse the system. Phenomena such as underground economic activities, tax evasion, the taking of abusive leaves, shirking on the job, and so on grew over the years and reached worrisome levels in several countries and especially in those with high taxes and high public spending.[2] Assar Lindbeck, 1995, has called their growth “hazardous welfare-state dynamics”. These problems of economic governance that have equity and efficiency implications have challenged the legitimacy of the social contracts between the citizens and the state that are at the base of the welfare states and have weakened the scope for collective action. Problems of vertical and horizontal equity for taxpaying citizens have become more pronounced over the years.

Given the high and growing tax levels most individuals lost their ability to make the individual choices that they would have preferred. They were forced to accept the public

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[2] For example the paid abusive leaves from public jobs amounted to 17.1 days in Italy in 2005. In parts of the public sector the abusive leaves were as high as 31 days. Reported in Corriere della Sera, p. 18 (8 September 2008). Very high absenteeism has also been reported in Sweden and in other European countries. The fake claims of invalidity have also been a major problem in several countries.

choices made collectively. They lost part of their economic freedom in the use of their before-tax earnings. If they had been free to make their own choices, many would not have subscribed to this social contract. The governments themselves lost some of the freedom to pursue polices that they would have preferred because much of the budget was predetermined by past programs and past legislation and because a large number of citizens (pensioners, public employees, those receiving subsidies, etc.) had become dependent on the public programs so that they opposed significant changes.

Because of high tax rates in many European countries the difference between before-tax earnings and (after tax) disposable earnings became very large, especially for dependent workers. It often exceeded 50 percent of before tax earnings. This difference paid for the public services and the public pensions that the citizens obtained, or expected to obtain, from the state. As mentioned earlier, the taxes paid were a kind of risk premium for the expected public services and public protection. The programs had presumably beneficial redistributive effects, both vertically and horizontally. By and large, they contributed to better income distributions and lower Gini coefficients. These results have been reported to be one of the important and desirable outcomes of a larger government spending role.

While reducing some economic risks for many citizens and improving the income distribution, this government intermediation was costly in terms of individual economic freedom and in terms of efficiency in the allocation of resources. A pertinent question is what would have happened if the state had not stepped in with its larger spending role after World War Two.

Ignoring the cost in terms of reduced individual economic freedom, the high tax rates needed to finance the expensive public sector activities must have had a negative impact on

the incentives of many citizens in their economic decisions. There is a large literature that has identified and at times quantified the welfare costs of high tax rates. For example high social security taxes have made early retirement more attractive. See Gruber and Wise, 1999. High taxes have also discouraged second workers in families to enter the labor force. A more limited but still significant literature has done the same for spending programs. Some economists have gone as far as to attribute differences in the rates of growth, over recent decades, between the United States and the European countries to differences in tax rates. The more important are these welfare costs assumed to be, the less attractive the large government role appears to be <u>over the long run</u>. If taxes had not increased, the economies of the high tax countries would most likely have grown at a faster pace and their citizens would have benefited from higher per capita incomes that could have been used to buy from the market protection over economic risks.

For reasons identified especially by the "school of public choice" literature, government programs tend to be less efficient than private sector's programs, especially when the private sector is <u>efficiently regulated but not over regulated</u>. The reason is that government programs are not subjected to the discipline imposed by competition. There are no competitive pressures to keep costs down or the quality up of public services. When programs become public, they tend to become monopolies and often become tools for pursuing some purely political objectives. These objectives often result in excessive public employment, low productivity, high public sector wages pushed by unionized employees, creation of rents for some groups, and so on.

Some recent studies have estimated the inefficiency that has characterized high public spending in many countries. These studies have shown that the objectives sought by

these programs were often obtained at high costs. See, inter alia, Alonso, et al, 2005; Alonso et al, 2009; and Angelopoulos et al (forthcoming). Furthermore, one must add to these costs the macroeconomic costs generated by high fiscal deficits and public debts that often accompany high public expenditures.

It is an open question whether most citizens are myopic; or, if they are, whether they are more myopic than the policymakers who make the spending decisions on their behalf.[3] For example, the accumulation of large public debts in several countries, and, especially, of large unfunded future liabilities in public pension systems, can be considered as clear examples of policymakers' or governments' myopia. These liabilities have raised questions about the sustainability of current public programs and, implicitly, about the ability of these programs to be able to cover the future risks for the citizens at the promised level. Thus it is unlikely that future retirees will receive the pensions that they have been promised by the government, at the promised retirement ages and in the amount at which they expect to receive them. Thus, the myopia of some citizens must be compared with the myopia of the policymakers. While only some citizens can be assumed to be myopic, for public pensions at least it is the whole system that may be myopic. It is not obvious which myopia has more serious consequences. Evidence of governments reneging on their pension obligations under the conditions promised are not rare.

[3] The question of whether individuals are myopic or more generally irrational has been addressed in some recent books that have reported the results of experiments from behavioral economics. See Ariely, 2008 and Thaler and Sunstein, 2008. They have shown that some individuals tend to make irrational choices. Some of these choices imply myopia. Diamond's defense of the social security program in the USA is largely based on the assumption of myopia by individuals. See Diamond, 2004. But see Gruber and Wise, 1999.

IV. Is a Different Economic Role of the State Possible?

For much of recorded history (until recent decades) the world did not have governments that taxed their citizens with high rates and spent the money to finance public programs on behalf of the citizens. Still the world was able to get along and many countries developed comfortably. It is not widely recognized that some social protection was provided through means other than government programs. Existing "social norms", that made people behave according to some societal notion of fairness, helped in this direction. Some of these norms are still common in Asian countries.[4] Citizens made provisions against economic risks by saving part of their incomes. The fact that credit cards were not available and consumer credit was informal and limited made saving necessity. People remained economically active as long as they were able to work (rather than retiring at an officially imposed age). They had the support of extended families that operated like clubs for those who were parts of them. They relied more than they do now on friends and neighbors. They participated in private associations (confraternities, mutual assistance societies, religious groups etc.). They bought services from private providers (private schools, private doctors and hospitals, etc,). See, interalia Ritter (1996) and Wuthnow, editor (1991)[5]. The fact that at that time countries were much poorer than they are today, and thus personal incomes were much lower, meant that the programs were not generous, by today's rich countries' standards. At that time, if public sector's programs had existed, they would also not have been generous as they are not in poor developing countries. Thus, in comparing the present

[4] For example the norm that children are responsible for the welfare of aged parents, in the same way as parents are responsible for the welfare of their children, is still prevalent and in some countries it has legal backing.

[5] There is an extensive literature on these private systems of social protection mostly by sociologists and historians. This literature has been largely ignored by economists.

with the past it is important to separate the impact of much higher incomes from that of a much larger spending role by the government.

Private forms of governance also existed in various sectors and some continue to exist in particular industries. These forms can exploit the superior information and expertise that their members have to privately regulate and enforce good behavior on the part of their members. See Bernstein, 2001. Thus, it must be recognized that before governments started intervening on a large scale in providing social protection, several countries had spontaneously developed significant private programs that (taking into account the low income levels of the time) did a reasonable jobs in providing some of the basic assistance that the individuals and their families needed. See various paper in Wuthnow, editor, 1991; and Beito 2000; and Beito et al, editors, 2002.[6] During his trip to the United States in the 1830s, de Tocqueville had been impressed by the extent of voluntary associations and warned about the danger that the government would crowd them out. Tocqueville, 1835.

When the public programs came into existence, these private programs were generally, and at times forcefully, crowded out. Where the government intervened less, they remained more active. Using Ariely's terminology, when the welfare state was introduced, existing "social norms" were progressively replaced by "market norms." Citizens felt that since the state had assumed that responsibility, they were no longer required to assist others. In some sense there was a decline in social capital. Ariely shows that citizens are more

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[6] These authors have shown that in the mid-1800s, 95 percent of English children went to private schools and their parents spent for education a share of total national income equivalent to today's spending. Furthermore, the schools provided the students with an education and training that matched more closely the market's needs than public schools now do.

efficient in these activities when prompted by social norms than by government programs.[7]

Let us conduct a simple thought experiment. Assume that it were possible to abolish government programs that now require high tax levels to be financed. In this experiment we ignore transitional problems that, in reality, would be politically very important. Ignoring these transitional problems makes the experiment a bit unrealistic, especially on political grounds. For example, individuals who are already retired would expect and deserve to continue receiving their government pensions. Those not yet retired, who have already contributed over many years to their future public pensions, would expect the government to live up to its promise when they retire. Those who hold government jobs, with tenure on their jobs, would expect to continue to receive their government salaries, and so on. Thus, our thought experiment must be interpreted to include a substantial transition period, a period that could extend well over one generation.

The abolition of the government programs would significantly reduce the need for high taxes. This reduction would translate into potentially large increases in the present and future disposable (after tax) incomes of most citizens.[8] These higher, disposable incomes would make it possible for citizens (using the extra income) to buy, from the (domestic or possibly foreign) market, or from civic associations, some of the services (some of the protection against the economic risks) that they had been buying indirectly, through the intermediation of the government, with the heavy taxes that they had been paying. This assumes that adequate though not perfect markets would exist either domestically or abroad.

[7] In several of his writings, Kenneth Arrow has called attention to the fact that the intervention of the government is not the only way, or necessarily the best way, to satisfy social needs. See Arrow, 1977; and Dixit, 2009. Of course many economists, especially from the school of public choice have made the same point and have at times suggested elaborate schemes that would lead to the voluntary production of public goods.

[8] Ignoring short run, potential Keynesian effects, it can be expected that future disposable incomes would be increased by lower taxes but also by higher rates of growth.

In the new situation the government would face a fundamental choice: to wash its hands and let the citizens (in the future) do whatever they wished to do with their extra income; or to impose some constraints on the use of that income in order to attempt to continue promoting objectives that the government had been pursuing previously. This is a fundamental philosophical dilemma.

In the first alternative the government could either assume that most citizens are responsible and rational (rather than myopic and irresponsible); or simply assume that, regardless of their behavior, they must bear responsibility for their own actions, whatever those actions might be. In this alternative the complete freedom of the citizens (to be responsible or irresponsible) would be respected. This is the kind of world that very conservative economists or philosophers favor. The philosopher Robert Nozick, author of Anarchy, State and Utopia, 1974, is the most prominent exponent of this "minimalist state" alternative. As a reviewer of Nozick's influential book put it:

> "…Nozick holds that each person is a separate individual with inviolable right to live as he chooses, provided only that he respects the similar right of other individuals. These rights include the rights to be free from interference…they do not include the right to any uncontracted assistance from others… See Lacey, 2001 pp. 20-21.

Critics of Nozick find his position rather extreme. One problem with it is that, willy-nilly, total individual freedom can generate significant negative externalities for other people who live in the same community. This is obvious for externalities associated with contagious illnesses and extreme poverty. My welfare may be reduced by the existence of very poor or sick people in the area where I live.[9]

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[9] Perhaps it should be added that the private network of assistance that had existed in the past and that had been crowded out by the introduction of government programs may not come back. Also Nozick would probably argue that nobody would prevent me from freely encouraging the very poor to move away from where I live, through the payment of some money. Thus, in theory, Coasean

The second, less extreme and more realistic, alternative would be for the government to choose a more paternalistic but more pro-market approach and require that the citizens buy directly from the private market, with their own incomes, (or, in some cases, with cash transfers that the poorest among them could receive from the government or from civic association) some of the protection against fundamental economic risks that they had been getting previously from the government, through the payment of higher taxes.[10] This approach would be consistent with the results of experiments from behavioral economics that have concluded that <u>some</u> individuals tend to make irrational choices when they are completely free to choose. See Ariely, 2008 and Thaler and Sustein, 2008.

A paternalistic role is already played by governments when they require individuals to: (a) get insurance for their cars and get the cars inspected; (b) have fire alarms in their buildings; (c) wear seat belts (helmets) when driving cars (motorcycles); (d) quit smoking in public places; (e) get vaccination against some illnesses even for non contagious diseases; (f) live in structurally safe buildings; (g) attend school until a given age; and so on. Under a pro market but paternalistic role the government would require individuals: (a) to buy some basic medical insurance; (b) to acquire pension rights (or to accumulate financial assets for old age through individual retirement accounts or through other channels); (c) to send children to (private) schools or to provide in-house schooling; and so on.[11] That role might

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contracts could deal with this externality. See Coase, 1994, especially Chapter One. In practice it is not likely that these contracts would take care of the problem.

[10] It should be mentioned that Milton Friedman and George Stigler recognized some paternalistic role on the part of the government. See Friedman, 1962, Chapter II, and Stigler, 1963. Both of them saw part of this role satisfied through cash transfers to individuals.

[11] Home-schooling has been growing in popularity in some countries and especially in the United Kingdom and the United States. The use of the internet for providing teaching is making this much more feasible. In a world in which each family had internet availability one could even conceive the elimination of schools as we now know them and require home teaching for all children.

extend to or require some regulation of enterprises' behavior[12]

This paternalistic approach, as a substitute to public spending programs, already exists in some limited form in several countries. Following the (1981) example set by Chile (or perhaps that introduced much earlier through TIAA-CREF pension programs for professors in American universities) several countries have introduced requirements for their workers to allocate a given percentage of their earnings to personal accounts that are privately invested and that are expected to grow in value over long periods of time, thus providing the workers with financial resources in their old age. These programs are based on "defined contributions" rather than "defined benefits." The contributions are fixed by law as a proportion of yearly incomes. The benefits depend on the contributions made, the rate of return on those contributions, and the age when the individuals decide to retire and to start to draw from their accounts. Some countries require their residents to buy private health insurances. Others require them to put money into special, personal "health accounts" (Singapore) to be used first in case of illnesses, before public money becomes available.[13] In many countries (United States, United Kingdom, several Latin American countries, India) private schools have become a common feature and many families send their children to these schools, even though free public education is available. These schools provide better and more easily marketable education than public schools. Some countries provide vouchers to the parents of children that choose to go to private schools.

There is little doubt that, should governments give up their monopoly power over some of these sectors (pensions, health, education, infrastructure, others), especially in

[12] This could especially the case in the medical area to prevent medical enterprises to pick the individuals that they insure, i.e., cream skimming. Medical enterprises would be expected to discriminate only by age and not by previous medical conditions.

[13] There are now at least 11 countries (plus the state of Massachusetts) that require mandatory health insurance. See World Bank, 2008. One (Singapore) requires health accounts.

today's world, private sectors' alternatives would quickly appear. Some of these alternatives would be better than others and some might be available abroad. In past decades these alternatives were not available in many countries because the government prohibited them, or because it provided "free" options for overtaxed citizens thus sharply reducing the latter's incentive or ability to rely on the private sector. See Tanzi, 2005. In some countries, because of legal reasons, certification from private alternatives were not given the same value. For example, diplomas from private schools, were not given weight in getting government jobs. Also, markets were then more closed and less sophisticated than they are, or can be, today. [14]

In today's world, technological and policy developments have contributed to make many markets potentially more efficient and wider than before. The use of the internet has also contributed to this. By giving consumers free access to prices and other information, the internet has increased competition and the efficiency of markets. Much more progress is possible. However, in this new and more global world, governments must play a more efficient role than in the past in regulating private markets, to prevent abuses and to force a greater and clearer distribution of reliable information for the citizens. They must also play a greater role to assure that the markets are more widely available to all citizens. Thus the role of the state would change from providing public services to efficiently regulating particular sectors of the market. This important regulatory role for the government connected with its paternalism role has attracted relatively little attention in discussions of the economic role of the state. In view of the current financial crisis it deserves far more attention. See Tanzi, 2008. This aspect is discussed further in Section V below.

[14] Of course the lack of complete markets in some areas might create some difficulties. These have to be compared with shortcomings in government programs. Also, where capable, the government can intervene with its regulatory power.

In this paternalistic role the government might have to provide to the very and deserving poor the financial means that would allow them to buy directly from the market some of the essential services (basic education, basic health and perhaps a minimum pension) that they had been getting free, or almost free, from the state. Thus, the government role would move from providing universal to targeted assistance; and the targeted assistance, would be directed to limited and special groups. Universal assistance, as provided by many European countries, is much more costly fiscally but is easier administratively and politically. It is easier politically especially when it is assumed to satisfy "civil rights" that have become entitlements. Entitlements become property rights against the community. As such they become a challenge against private property rights. Targeted assistance is more difficult politically and administratively because it requires means testing, the identification of categories of beneficiaries, and decisions as to levels of income or other characteristics at which one acquires the right to public assistance.[15] Means testing may be more difficult now than in the past because of greater difficulties in getting reliable information on individuals and families, in a more mobile society. In the distant past, for example, parish priests or members of mutual assistance societies had much better direct information on the economic situation of each family within their area. See Beito et al, 2002 and Solomon, 1972. However, modern technology and the communication revolution has created new sources of information not previously available. Some countries (Sweden) have enough information on residents to dispense from the need for a tax declaration .[16]

[15] Also questions of incentives created by poverty traps must be dealt with. These incentives become stronger when social norms become weaker. See Lindbeck et al, 2003. They become weaker when tax rates are low.

[16] Age can be used to provide cash transfers to individuals. For example children up to a given age could get cash transfers to be used to buy educational services from the private sector. People over a

Some sociologists have pointed to what has been called the paradox of redistribution that indicates that, when the incomes generated by the market are unevenly distributed, a large public spending can reduce income inequality even when the public programs are universal, and even when higher income classes get larger shares of the spending of these programs. See Korpe and Palme, 1998. In most countries much of the redistributive effect does not come from the tax side but from the spending side. It requires high tax levels and high public spending. See Table 1. It is argued that these high-spending, universal programs achieve more redistribution than would targeted programs because the latter would not get the political support needed and thus they would not be introduced.[17] It is concluded that the high-spending, welfare states have reduced inequality more than the Anglo-Saxon countries that have relied on more targeted programs and less public spending.

If reducing income inequality were the main objective of the state's intervention, and if money spent on the poor were actually received as cash income by the poor, then the superiority of universal programs in providing better Gini coefficients would be clearer. However, in a competitive and globalizing world, reduction in inequality cannot be the sole or the main objective of economic policy. If that were the case, the policies pursued by the

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given (advanced) age could get minimum pensions. Policies based on asset accumulation could be part of this new role of the state. See, Moser, editor, 2007, for examples.

[17] This argument conflicts with "the common political economy hypothesis (often attributed to the late Mancur Olson) that a combination of specific benefits and general taxes generates strong pressures for continuous expansion of government spending. See Lindbeck, 1995.

Table 1

Redistribution in OECD Countries: Effects of Taxes and Transfers

	Gini Coefficients			**Share of Redistribution Contributed by**	
Country	**Private Income**	**Disposible Income**	**Fiscal Redistribution**	**Taxes**	**Transfers**
Belgium	.465	.242	.223	28.0	72.0
Sweden	.441	.223	.218	17.5	82.5
Netherlands	.458	.257	.202	20.4	79.6
Finland	.417	.223	.194	24.4	75.1
France	.469	.292	.177	12.0	88.0
Denmark	.412	.245	.167	21.2	78.8
Germany	.421	.254	.167	27.9	72.1
United Kingdom	.475	.323	.153	20.7	79.3
Norway	.379	.235	.144	27.9	72.1
Australia	.423	.297	.126	39.3	60.8
Canada	.406	.290	.116	33.0	67.0
USA	.447	.345	.102	44.7	55.3
Switzerland	.396	.299	.097	12.4	87.6
Mean	.432	.271	.160	25.4	74.6

Source: Adapted from Jesuit D. and Vincent Mahler, V, 2004, “State Redistribution in Comparative Perspective: A Cross-National Analysis of the Developed Countries”, LIS Working Paper, No. 392, November 2004.

planned or socialist economies, including Cuba today, would be universally praised. They deliver good Gini coefficients but little economic growth over the long run.[18]

Furthermore, we must recognize the possibility that some (or much) of the money that is presumably spent on the poorer income groups may be siphoned off, toward the middle classes, through high public salaries, inefficiency, and other channels that benefit those who administer or deliver the services (school teachers, nurses, doctors, public administrators, etc.) but help little those who receive the services and to whom the benefits (and the spending connected) are attributed. Those who deliver the government services generally do not come from the poorest classes but generally from groups in the upper half of the income distribution. The paradox of redistribution simply assumes that the money spent on providing services to some groups is equivalent to the real benefits received by those groups. This assumption is often not warranted when the benefits are not received in cash. See Tanzi, 1974, and Goldstein and Estache, 2009.

In addition to the implicit, vertical redistribution (of parts of the benefits of government programs provided in kind), from recipients of the benefits to those who administer or deliver the services, there is also the important horizontal redistribution from those who actually make use of the services to those who because of their particular circumstances do not use them. For example, for workers who pay high taxes but have no children and, because of good health habits (do not smoke, they exercise, and have a health diet, etc.), develop less illnesses, the welfare state is no bargain. This important aspect of horizontal inequity has not received attention. The assumption is generally made that citizens benefit equally from social services; or, if they do not, they value the implicit insurance equally. Benefits paid in cash do not suffer from this problem although they may suffer from other problems. See Currie and Gahvari, 2008.

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[18] There is also the more technical question of whether Gini indices are the best measures of income inequality. See Ravallion, 1996.

Finally, the author of this paper has argued in several papers that globalization and other developments are making progressively more difficult and more costly for countries to maintain the current high average tax levels. “Fiscal termites” have started to weaken the tax systems. See Tanzi, 2001 and 2002. This means that universal public programs may become progressively more difficult to finance, than in past decades. This will force a different role for the state in the future, one with less public spending and lower taxes. At the same time, globalization could make it easier for countries to use targeted cash transfers that would allow low-income and other deserving citizens to buy some of the services and the protection against particular risks more cheaply outside their own countries. For example, health tourism has been growing very fast allowing citizens of rich countries without public health to buy particular costly health services, at bargain prices, from poorer countries, such as India.[19] Some costly, educational services could also be bought from other countries. In time even the care of the very old could be bought abroad at much cheaper costs.[20] There is also no valid reason why the savings to be used in old age could not be invested internationally in well-monitored and safer investments with broad coverage and low management charges such as worldwide index funds.

In all the developments mentioned above the state must continue to play an important but different role. It must play a far more vigilant and effective regulatory role than it has in the past. The key question remains whether it would be able to do so fairly and efficiently. If the answer to that question is positive, a new role of the state would definitely be possible. That new role would require less public spending and less taxation but more direction and regulation and more nudging on the part of the government. It would be a form of libertarian paternalism.

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[19] Some of these services include hip replacements, for older people, open heart surgery and similar ones.
[20] In some ways this is already happening. The difference is that now those who care for the old are imported rather than sending abroad (rather than to domestic nursing homes) the elderly.

V. The Fiscal Impact of the Crisis

The financial crisis that hit the world economies in 2008 was quickly followed by sharp falls in real output in many countries, at rates not experienced since the Great depression. Unemployment rates have gone up and are likely to continue rising for some time. Tax revenues have fallen sharply and so have fiscal revenue from commodity price movements for commodity exporting countries. The two features that have made the current recession unusual are: (a) how quickly the crisis spread from the United States to other countries; and (b) how global it became, compared with earlier financial crises that had generally been limited to one or a few countries.

Many observers have considered the current crisis as a clear evidence of widespread market failure. They have called on governments to step in and play a larger role both, in the short run, in stabilizing the economy, and, in the long run, in expanding public sector activities and public spending. The rallying cry from many observers has been more government and less market. The crisis has provided a convenient argument to push for more government spending. At this time we are still at the short run part of the fiscal expansion. It is too early to predict what the long run will bring. However, inevitably short run actions will have major long run consequences. It now appears likely that the countries will come out of the financial crisis and be confronted with a fiscal crisis. And fiscal crises are more difficult to solve.

To stabilize the economies, governments have been using extraordinary monetary and fiscal tools, the kind of tools that we used to associate with Latin American countries in the 1970s and 1980s. In some countries, central banks have become de facto off-budget budgets, and ministries of finance have been adding large fiscal stimuli, consisting mainly of public spending, on top of the large increases in fiscal deficits due to built-in stabilizers. The current fiscal actions have ignored the literature of recent decades that had concluded that discretionary fiscal policy (the one associated with fiscal stimuli) is not likely to have much of an impact, for

both technical (less) and theoretical (Ricardian effects) reasons. It should be recalled that the literature had always been less negative about the use of built-in stabilizers than about discretionary fiscal policy. Governments have also ignored the literature that indicates that monetary expansion often leads to high inflation which in turn may lead to falls in tax revenue. See Tanzi, 1978.

Various institutions (IMF, OECD, ECB, European Commission) have been estimating the impact of the crisis on fiscal variables. Table 2 provides the latest estimates by the European Commission for eight individual countries and for the EURO AREA-12. The data refer to the general and not central government. They are final data for 2007 and forecasts for 2010. The

Table 2
General Government Balance, debt, and Public Spending
(in percentages of GDP)

Countries	**Balance**		**Debt**		**Spending**	
	2007	2010^{p}	2007	2010^{p}	2007	2010^{p}
United States	–2.8	–14.2	63.1	91.1	37.4	43.7
Japan	–2.1	–8.7	173.6	194.0	36.4	46.7
United Kingdom	–2.7	–13.8	44.1	81.7	44.0	52.4
Germany	–0.2	–5.9	65.1	78.7	44.2	49.0
France	–2.7	–7.0	63.9	86.0	52.3	56.4
Italy	–1.6	–4.8	104.1	116.1	47.9	51.1
Spain	2.2	–9.8	36.2	62.3	38.8	47.1
EURO AREA-12	–0.6	–6.5	66.1	83.8	46.1	51.1

Source: European commission. Spring 2009 forecasts.

^{P} = forecast

year 2010 is the year when countries are expected to emerge from the crisis. Thus, the table provides a forecast of the impact of the crisis on fiscal variables. Table 2 gives estimates for public spending, fiscal balance, and public debt, all as shares of GDP. It should be noticed that, even though 2007 was a good year for the economies, all countries shown in the table, except Spain, were running fiscal deficits and had high public debts.[21]

The table shows the remarkable increases in public spending as a share of GDP between 2007 and 2010. The increases range from a low of 3.2 percent of GDP for Italy to a high of 10.3 percent of GDP for Japan. The increases for the UK, 8.4 percent, and for Spain, 8.3 percent, are also remarkable. For the United States the increase over the three years is forecast to be 6.3 percent of GDP. Of course some of these increases are due to the fall in the denominator, GDP, rather than the increase in real spending.

The general government balance, that includes the deficits of local governments, is shown to increase dramatically between 2007 and 2010. In the Untied States and the United Kingdom the fiscal deficits rise to around 14 percent of GDP, levels not seen since World War Two and much higher than those experienced during the Great Depression. In all the other countries the increases are also dramatic, especially in Spain and Japan. These increases in fiscal deficits results form the combination of the falls in GDPs and in taxes and the increases in public spending. These could not fail to affect the shares of public debts into GDP, due to the well-known mathematical relationships that exist with the nominal growth rate of the economy, the nominal interest rate, and the primary balance. See IMF, June 9, p. 33. The public debts of all the countries in the table shoot up, some to dramatic levels. See Table 2.

[21] See also the analysis in IMF, June 9, p. 209.

The figures in Table 2 refer to 2010 and generally assume the end of the current crisis. They do not tell us what happens beyond 2010 and what could happen if the crisis continued beyond 2010. It is difficult, at this point in time, to make projects that extend into the distant future. These projects would inevitably reflect the expected increases in public expenditures due to population aging and the continuing effects of the crisis. They would reflect increases due to pensions, healthcare, and long-term care and the impact of the crisis on tax revenue and rates of growth. Table 3 provides some of these projected, expected increases in public spending, due to demographic charges, from 2007 to 2060 for a few countries. Even without the impact of the crisis, these increases would be difficult to accommodate for countries with already high taxes, high deficits, and high fiscal public debts.

Table 3
Expected Increases in Public Expenditures Due to the Ageing of the Population: 2007-2060
(Percentages of GDP)

Country	Pensions	Healthcare	Long-Term Care	Total
Germany	2.3	1.8	1.4	4.8
Spain	6.7	1.6	1.7	9.9
France	1.0	1.2	0.8	2.7
Italy	–0.4	1.1	1.	1.6
Netherlands	4.0	1.0	4.7	9.4
United Kingdom	2.7	1.9	0.5	5.1

Source: European Commission and Economic Policy Committee (2009), The 2009 Ageing Report: Economic and Budgetary Projections for the EU 27 Member States (2008-2060). Brussels.

For the United States that is not included in the table the longer run outlook is even more worrisome. See Auerbach and Gale, June 2009; and Congressional Budget Office (CBO), July 2009. Both of these documents conclude that "the current policies are unsustainable". If maintained, and under rather optimistic assumptions, they imply fiscal deficits (for the federal and not the general governments) of 7 percent of GDP in 2020, and public debt of more than 100 percent of GDP by 2023. Under current policies, the public debt of the US federal government is projected to rise to 650 percent of GDP by 2076! To these federal deficits and debts one has to add those of the sub-national governments that in 2009, have experienced the sharpest decline in tax revenue on record. See Boyd and Dadayan, July 2009. As the late economist Herbet Stein famously said, "if a trend [or a policy] is not sustainable, it will not be." Thus, a public debt of 650 percent of U.S. GDP will not happen. Those who are calling for even larger fiscal stimuli are inviting the irresponsibility of politicians.

There is now a lot of talk about "exit strategies", under the growing realization by some that the Titanic maybe running fast toward an iceberg, even though the iceberg may be at some distance so that the music could still play for a while longer. In the past "exit strategies" for very high public debts have been almost always high inflation and, some time, high growth. High growth is not likely to materialize over the next several years because the major distortions caused by the crisis and the fall in investment have reduced potential output. The need to raise savings in several countries, and especially in the United States, will also not help. Additionally, the growth rates of recent years, in several important countries such as the United States, the United Kingdom, Spain and some other countries, had been inflated by the overbuilding of houses, and by the excessive earnings that had gone to the financial market. These had inflated the growth rates but also tax revenue. Hopefully, inflation will not be the solution, although we cannot e sure of this. This leaves the difficult option of rethinking what the role of the state

should be in the future. Rather than "less market and more state" most countries will need policies consistent with "less state and more regulated markets". This would be a genuine exit strategy.

VI. The Role of the State in the Future: Some Concluding Remarks

Before the current crisis started, many countries had been running large fiscal deficits, had significant public debts, and, especially the European countries, had levels of public spending and taxation that were high shares of their gross domestic products. As already mentioned, these countries are facing demographic changes with major implications for their future public spending and intergenerational accounts. The full effects of these demographic changes will begin to be felt fully in the next few years. Before the crisis many economists had considered the fiscal impact of these developments already unsustainable. The crisis is making them much more so. Given the above circumstances, and ignoring the question of how these huge fiscal deficits will be financed, without running the risk of high inflations, and whether they will have the desired effect, it is not clear what giving a larger, permanent, economic role to the state could mean. It should not mean asking governments (or at least most of them) to assume permanent, larger spending responsibility which would require much higher taxes or borrowing.

If, before the economic crisis, the countries had had low tax levels and well balanced fiscal accounts it might have been possible to rewrite the implicit social contracts, between the governments and the citizens, to accommodate larger public spending. The citizens would pay more taxes and the governments would spend more on free or highly subsidized, public services. However, only a few countries might be able to significantly raise their tax levels. Therefore, the option of expanding social spending by increasing tax levels, is not likely, to be feasible, either

politically or economically. Because of the high public debts, borrowing will also not be an option.

If the activities of the state have not been satisfactory or efficient up to now, policies that might improve them (without increasing public spending) should definitely be considered. Countries that have been satisfied with the level and the composition of their public spending programs, should not change them, provided that they can still finance that level.[21] For others, Section IV above suggested some possibilities for reform. However, these possibilities require time and depend significantly on the existence of reasonably well working private markets. Thus changes in the economic role of the state cannot be separated from reforms and improvement in the functioning of the private market. The two must be seen as going together. In the reforms of the private market the state must play a significant role. The idea that the market are always self-correcting is an illusion. This market–improving role should be considered the most fundamental role that the state should play in a market economy.[22]

In spite of statements often heard today--that the market has failed and that this has created a stronger case for its replacement by the government -- the truth is that much (though not all) of the market, before the recession, had been functioning reasonably well in most countries. Probably it had been working better than the government in all its activities.

In the <u>real</u> part of the economy the market had been working reasonably well, although not perfectly. In most sectors efficient firms survived and less efficient ones disappeared. Prices went up when the demand increased, or when costs of production went up. They went down when the reverse occurred. Productivity gains were common and contributed to growth. There were no significant cases of scarcity. Most goods were readily available and in adequate supply.

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[21] As Paul Samuelson put it five decades ago: "There are no rules concerning the proper role of government that can be established by a priori reasoning". See Samuelson, 1963.

[22] This is a fundamentally different role from the one that asks the government to replace the market because of market failure. It can be seen as a <u>market augmenting</u>, rather than as a <u>market replacing</u> role.

For many goods and services, though not all, there were no significant examples of asymmetric information distorting market relations. Many existing monopolies were government-created or government-protected (through patents or other means) and many former monopolies had ceased to be monopolies because of technological innovations, competition from globalization, and deregularization.

The part of the market that failed dramatically, creating in more recent years creating various problems, including the onset of the current economic crisis, is the financial market. It failed because it become too complex and incapable of valuing risk. It also failed because it contributed significantly to the increasing income inequality that characterized many countries in recent years.[23] Unfortunately, the financial market is fundamental for making possible some of the alternative roles of the state suggested in Section IV. If it would be desirable or necessary for the government to reduce the role it plays through its public spending (without giving up its paternalistic role), the private market, and especially the financial market, must work better than it had in recent years. In recent years several influential economists including some recipients of Nobel Prizes in economics, associated with "The Chicago School", promoted the idea that markets, including the financial market, do not need the steering hand of the government because they are self regulating. An invisible hand guides them toward increasing efficiency, if only the government stays out of the way. See van Overtveldt (2007).

This, so-called "market fundamentalism" came to be widely accepted by individuals who had market power and influence, including Alan Greenspan, Robert Rubin, Larry Summers, and others. This view ignored problems that complexity, asymmetric information, greed, poor

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[23] In the United States the financial market's share of total domestic corporate profits increased from about five percent in the 1940s to about 20 percent in the 1980s, and to 41 percent in 2002. This had a large impact on income distribution because of the extraordinary salaries paid by financial institutions. Also the increasing difference between the salaries of managers and those of workers in the corporate sector has been another cause of the increasing income inequality.

governance, increasing inability to value risk, and the existence of incentives that encouraged the generation of quick profits could generate. See Tanzi (2007). Government regulators and monetary authorities, that could have stopped these developments but preferred to look the other way. Ideology replaced analysis and guided some governments and especially that of the USA. The regulators were not given either the resources or the tools and the incentive needed to regulate.[24] It can be argued that the failure of the financial market was not a market failure but a spectacular example of government failure.

A well working financial market is essential to today's economies as is a well working real market. They are also both important in determining the economic role that the state can or should play. Efficient and more globally-coordinated regulation for the financial market is a sine qua non. This is the area where governments must perform better, both individually and collectively. There is now much discussion, at high international levels, of the need to create effective regulators, to increase contacts among regulators from different countries, to reduce the complexity of financial instruments, to create better incentives for market operators, to create less opaque instruments, and to provide more and more-transparent information to those who invest their savings in the market or get loans from it. If fully and efficiently adopted and enforced, these regulations would likely help improve the working of the financial market (as well as the income distributions) thus reducing the pressures on governments to do more. However, governments should continue to have responsibility vis a vis the truly deserving poor. Effective programs are necessary to deal with this need. Making benefits selective should be seen as the equivalent of excluding from access to them those who do not need them.

It would be a mistake to return to the overregulated financial markets of decades ago, that amounted to "financial repression". Innovation in the financial market is essential and will

[24] Also those who were put in charge of regulations did not seem too interested in regulating effectively. See Tanzi, 2008.

continue to be essential to growth so that it should not be stopped. However it must take place while the features mentioned above are satisfied.[25] It would also be a mistake to interpret the current crisis as a signal that globalization is a bad phenomenon so that countries should go back to the autarkic policies of the past. The return to closed economies combined with financial repression would be a tragedy.

The wise course of action would be to keep the economies open, to provide temporary boost to aggregate demand, to make the reforms needed in the financial system and in other areas, such as corporate governance, and to prepare for the after-crisis world that, in all probability, will see the countries emerge from the crisis with higher public debts and fiscal deficits and reduced means to sustain high public spending. It is also likely that the years after the crisis will not be years of high growth. That will not be the time to introduce new spending programs but the time to reform existing programs away from spending and toward greater reliance on other tools in order to make the role of the state efficient and sustainable. It should be possible to promote traditional, legitimate government objectives with less public spending, better markets, and some more paternalistic guidance. Genuine reform should not require the abandonment of those objectives.

[25] for example, it has been shown that access to credit by poor people, and access to institutions where they can easily and safely deposit their meager savings is very important. The provision of micro-finance has been a major financial innovation.

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