GOVERNMENT VERSUS MARKETS

This book is the first comprehensive treatment available in the literature of the economic role of the state in a historical and world perspective. It addresses the fundamental question of what governments should do, or have attempted to do, in economic activities in past and recent periods. It also speculates on what they are likely or may be forced to do in future years. Although other recent titles in economics deal with normative theories, public choice theories, welfare state analysis, social protection, and the like, no other book has the same breadth or depth specifically on the state's viable economic role. The author's knowledge of several languages has allowed him to draw from different and often inaccessible previous publications. The investigation assembles a large set of statistical information that should prove useful to scholars and policy makers in the perennial discussion of government's optimal economic roles. It will become an essential reference work on the analytical borders between the market and the state and on what a reasonable "exit strategy" from the current fiscal crises should be.

An economist of international renown, Vito Tanzi served for 20 years as director of the Fiscal Affairs Department of the International Monetary Fund in Washington, D.C., with which he was affiliated for nearly three decades. He also taught at George Washington University and American University. Dr. Tanzi is the author of 14 books, including *Public Spending in the 20th Century: A Global Perspective* (Cambridge University Press, 2000, with Ludger Schuknecht) and *Inflation and the Personal Income Tax* (Cambridge University Press, 1980), and edited 11 other titles with contributions. A former undersecretary for economics and finance of the Italian government, he was president of the International Institute of Public Finance (IIPF) from 1990 to 1994 and is the IIPF's Honorary President. Dr. Tanzi is known for the Tanzi effect, or Olivera-Tanzi effect, which refers to the diminished real value of tax revenues in periods of high inflation owing to collection lags. He has served as a consultant to the World Bank, the United Nations, the European Commission, the European Central Bank, the Organization of American States, the Inter-American Development Bank, and the Stanford Research Institute. Dr. Tanzi received his doctorate in economics from Harvard University in 1967. He holds five honorary degrees.

Government versus Markets

The Changing Economic Role of the State

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To my late father

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Preface

There is no more fundamental question in economics than what role the state or the government should play in a country's economy. How wide and deep should such a role be in a market economy? What should the state do? How much should be left to the market and to the free economic decisions of individuals or groups of citizens? How should the state perform its role? What instruments should it use? The French poet Paul Valéry once wrote that "if the state is strong, it will crush us; if it is weak, we shall perish." Philosophers from Plato through Hobbes, Locke, Hume, Rousseau, and others, have addressed the question, focusing mainly on the political role. As in many other human activities, the secret is in finding the right balance. As noted by President Barack Obama at his inauguration, the aim is to find a government that works well.

Who decides what is the right balance? Few question that the state must play a significant role in an organized, modern society, or that organized societies need a government. The more significant question is what such a government should do and how it should do it. As with many things in life, the problem is to find the optimal dose of intervention, between one extreme, set by "centrally planned economies," where those who claim to represent the state make all the economically relevant decisions on behalf of the citizens, and the other extreme, set by the "laissez-faire ideology," where the role of the state is confined to a few basic or essential functions. To determine the right balance between these two polar conceptions ought to be the goal of economists and of intelligent and wise policy makers.

The state uses many tools or policy instruments to carry out its functions. It uses assets that are owned or have been inherited by the state, may have been bought from the market, or may even have been expropriated from their legitimate owners. It taxes individuals and enterprises on their incomes, their transactions, and their wealth. It subsidizes others. It borrows and lends money. It regulates the actions of individuals and enterprises. It prints money and uses the revenue that it receives from "seigniorage." It authorizes or forbids some activities. It certifies the qualifications of individuals who perform particular functions, such as physicians, pilots, and lawyers. Although some of the functions performed by the state are seen as necessary and useful, others may be questionable and may seem unnecessary or even harmful to some citizens. Some functions may be seen as too restrictive of individual freedom and could be delegated to the market that, if it is working well, might be able to deliver the services at lower costs.

The search for an optimal economic role of the state is an important and difficult one. It cannot be assumed that the current role is necessarily optimal. That role may have been promoted by events that required state interventions no longer considered necessary or even by mistakes. And it cannot be assumed that the role of the state in the past would be optimal today because the economy and the society may have changed, requiring different interventions. In some sense, the role of the state should continually be adapting to new developments. It must be seen as an evolutionary role that adjusts to the changing ecology of the market and, at the same time, influences that ecology. However, it should change according to certain rules or principles.

In textbooks and in articles in professional economic journals, it is often argued that the guiding principle that should justify state intervention in the economy should be "market failure." When markets fail, or are expected to fail, the state must intervene. This principle guided governmental intervention for much of the past century and especially for the past six decades. This principle may have contributed to the large growth in public spending because new, presumed, market failures were being found all the time. However, while market failure is obviously a useful principle, it fails in some fundamental aspects. First, it ignores the impact of current state intervention on the future development of private markets. Second, it tends to see market failure as a static and not a dynamic outcome of ongoing changes, including those promoted by the government itself. Third, it defines market failure in a purely technical manner, whereas for many citizens market failure may have a wider meaning. Finally, and related to the first point, the market failure approach fails to realize that, once the government intervenes in the economy to replace the market, it often creates its own monopoly in the sector or in the activity in which it has intervened. This often prevents, or at least makes more difficult, future developments of the private market or of civil society in that sector and in the economy. For political or bureaucratic reasons, the government has often shown a preference to *replace* the market rather than to correct its genuine shortcomings. Once the government has replaced the market – and, in doing so, has hired public employees and passed new laws – it has often been reluctant (or has not been allowed politically) to give up that new role.

The "market failure" approach does not recognize that the need for governmental intervention is not static: the private market is developing and changing all the time unless this process is prevented by the state. With the passing of time, the market becomes more sophisticated and potentially better able to satisfy many of the needs of the citizens. However, because the market often becomes more complex, it potentially requires different kinds of governmental intervention. It may create greater actual or perceived inequities that at least some citizens expect the government to correct. A free market is like an ecological system that undergoes a continuous process of evolution and adaptation. New technologies, new management techniques, growing globalization, and other developments have made today's markets potentially much more efficient and sophisticated in satisfying many of the people's needs; but they have also made the markets more complex and potentially less equitable. This means that, if governments directed their efforts more at promoting market efficiency and market equity and less at replacing the market because of its presumed "failures," governments could significantly reduce their spending and taxing roles while continuing to provide to most citizens the public services and the public goods that only state intervention can efficiently provide. However, the equity question would remain. Even the outcome of an efficient market might be seen as being inequitable by a majority of citizens. This equity question has become more important in recent decades and has often been used to justify more governmental intervention.

The reader should find this book informative and useful on a fascinating and enormous topic. Although it may not change many people's perception of what the state should do, if it encourages an honest and informed discussion it will have achieved a useful objective. This goal may be particularly important at this time when the financial and economic crises of 2008–9, and the government's reaction to them, have made future fiscal challenges more daunting than those in the past and the need for an efficient government role much more urgent and important.

The writing of a book such as this one is helped if the preparation of the author combines both relevant practical and academic experiences. At the cost of immodesty, I feel that I have had almost as much preparation as one can possibly have in this area. In different roles over a span of 27 years – as head of the Tax Policy Division (1974–81) and as director of the Fiscal Affairs Department of the International Monetary Fund (1981–2000) – I was in a privileged position for observing the behavior of many of the world's governments. During the 20 years that I spent as director of the Fiscal Affairs Department (FAD), that department had probably the greatest concentration of economists with a background in public finance and with Ph.D.s from the top universities in the world. FAD was also a frequent destination for some of the leading public economics scholars. They came to spend some months in a special program for visiting scholars. As a consequence, there was almost no problem or issue in public finance for which an expert could not be found. And there was almost no issue that had not been the object of some analysis or discussion in the department. I personally had to advise the governments of as many as a hundred different countries during the years that I spent at the IMF. This provided an ideal position for observing how governments operated in the real world and not just in the virtual world of theoreticians.

My IMF career had been preceded by my own strong academic background and by ten years of teaching graduate public finance. It was followed, in 2001–3, by an experience as undersecretary for economy and finance in the Italian government, a position that allowed me to experience the operations of a government from the inside. During those years, I wrote many papers and books and participated in numerous conferences that had to do with fiscal policy and, more generally, with the economic role of the state. Because of this almost unique background, narrow and purely technical issues that often drive a large part of the academic writing in this area have been deemphasized in this book. However, important theoretical issues that have real-life relevance have been discussed. Some available books that cover these theoretical issues well are now available.

Over some five decades, hundreds of individuals have influenced my thinking on economic and especially public finance questions, starting with those who first introduced me to the field of public economics. I will not attempt to list all or even many of these individuals, but I must mention a few. Because of the tyranny of time, some of them are no longer with us, including Gerhard Colm, who directed my master's thesis (on Nicholas Kaldor's expenditure tax); Otto Eckstein, who directed my Ph.D. thesis (on the relation between the personal income tax and economic growth); and Richard Musgrave, who was the second reader of my Ph.D. thesis and who influenced me in many other ways over many years. By coincidence, all three were refugees from bad governments, having left Germany in the 1930s.

In 1973–74, just before joining the IMF, I spent a sabbatical year in Italy, some of the time at the University of Rome. Part of the year was spent reading and collecting the works of Italian public finance economists who over the previous 100 years had contributed extensively to the development of public finance and had written much on the economic role of the state. In particular, I benefited from discussions with professors Sergio Steve, Cesare Cosciani, and Giannino Parravicini and with some of their assistants who became prominent economists in later years. At that time, these professors were important and influential scholars. That was a productive and especially pleasant year. It introduced me to the rich and diverse area that is the Italian *scienza delle finanze*, with its particular view of the work and the role of the government. That year had a permanent impact on my thinking which, until that time, had reflected much more the Anglo-Saxon perspective on various issues that was in vogue at the time. The Bank of Italy had partly financed that sabbatical year with a generous research grant. I am glad to convey to it a much-delayed thanks.

In more recent years, I have worked with Ludger Schuknecht, now at the European Central Bank, on some articles and on a book on public spending that have influenced parts of the present book. I also wrote several papers with another former colleague, Howell Zee. Both of these collaborations were highly productive. Finally, I conclude by thanking the librarians of the Joint Bank-Fund Library for invaluable help and Mrs. Jesusa Hilario, who patiently typed several drafts of this book. A special thanks goes to my wife, Maria, who made sure that distractions were kept to a minimum during the long period of writing. She took upon herself, with humor and kindness, the full and heavy responsibility of running the house.