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Excerpt
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Introduction

The economic role that states, or more narrowly governments or public sectors, in all their aspects, play or should play in democratic countries with market economies is a topic of great importance to countries, economists, political scientists, historians, and anyone else interested in economic policy and in economic development. It might be considered *the most important topic in economics*. As Jeremy Bentham put it three centuries ago, "the chief task of economists … is to distinguish … the Agenda of Government from Non-Agenda; and the companion task of Politics is to devise forms of Government … which shall be capable of accompanying the Agenda" (cited in Keynes, 1926, p. 40).

This topic has interested and fascinated me for a long time, at least since the years spent in graduate school, at Harvard, in the early 1960s; or, perhaps, without the full awareness of the importance of the topic, even earlier, while I was living in post–World War II Italy in the 1950s, during a highly politicized period. In those years there were frequent, heated debates among high school students. On one side of those debates were ignorant leftist students, some of whom, who called themselves socialists or communists, saw private property as theft and wanted to nationalize all the means of productions. They saw the elimination of private-sector activities and of private property as the obvious and simple solution to the Italian economic problems of the day. On the other side of these debates were equally ignorant students with centrist or rightist views and, in some cases, even with Fascist-inspired views, who did not believe in socialism or communism.

In those years, not long after the fall of the Fascist regime in Italy and the end of World War II, there were still many individuals around who were nostalgic about the Fascist period during which, they believed, order had prevailed, rules had been observed, and trains had arrived on time. There were also leftists, inspired by the strong political propaganda being disseminated by the then important Italian Communist

Party, a party that, in those years, was still strongly influenced by developments in Russia. Those developments had attracted and influenced many Italian and European intellectuals who had come to believe that the Soviet experiment, with central planning and the elimination of the private market, was pointing to a better future and a more equitable society, a society in which the *basic needs* of individuals would be satisfied by the state and everyone who could work would have a decent, government-provided job.

A few years later, in a very different environment and place – when I was a graduate student in economics at Harvard, during the exciting years of the Kennedy administration, and when the "Keynesian Revolution" was raging and reaching a peak in popularity in a place that was very much at the center of both of those events – Harvard – the question of what governments should do in the economies of countries that were not centrally planned and retained a market economy was receiving a great deal of attention, both inside and outside the classrooms.

At that time (early 1960s), the economic, scientific, and ideological challenges that were coming from the Soviet Union, then seen as a great military power and believed by many as having created a well-functioning and vibrant "centrally planned," or "socialist," economy, were strongly felt, especially after Russia had launched Sputnik into space, had shot down a high-flying American spy plane, and had exploded a hydrogen bomb, while also attempting to place missiles on the Cuban soil.

Before going to Harvard, and while a student at the George Washington University in Washington, DC, I had been lucky to have studied under a top public finance scholar, Professor Gerhard Colm. He was one of the many refugees from Hitler's Germany and, at that time, was the director of the National Planning Association in Washington. I had also spent six months working as a research assistant in a study group nested within the Joint Economic Committee of the US Congress. That group had been set up to prepare a report for the US government on the economic challenges coming from the Soviet Union. The study group had assembled among its staff several well-known academic economists and was led by a dynamic, young, and brilliant Harvard professor, Otto Eckstein, another refugee from Hitler's Germany. At that time Professor Eckstein, one of the youngest full professors at Harvard, was considered among the rising stars in the economics profession. The task of the congressional commission was to advise the American government on how to respond to the economic challenge coming from the Soviet Union. The commission produced an important study that was reported (by T. Sorensen, a Kennedy adviser and later biographer of Kennedy) to have played a significant role in influencing the thinking and policies of the Kennedy administration.

I had also spent another two years working for a Congressional-Presidential Commission (the Outdoor Recreation Resources Review Commission) that was tasked with determining the optimal use for the extensive public land owned by the US federal government. This commission produced several reports that set the stage for the future use of public land.

During the years I spent at Harvard, in the first half of the 1960s, some of the leading economists of the time – Paul Samuelson, Robert Solow, Simon Kuznets, Kenneth Arrow, Franco Modigliani, Wassily Leontief, Kenneth Galbraith, Robert Dorfman, Alvin Hansen, Otto Eckstein, James Duesenberry, and several others – were in the Boston area, either at Harvard or at MIT. Richard Musgrave, who was then considered the leading public finance economist in the United States, would come to Harvard a little later and would be the second reader of my doctoral dissertation; I thus completed my public finance preparation under a third refugee from Nazi Germany.

From different perspectives, all of the aforementioned economists were addressing the question of what the role of the state should be in a market economy with democratic institutions. They were trying to identify circumstances that would require, or justify, the intervention of the government in the operations of the economy, and how that intervention could take place without damaging, or replacing, the market and without excessively restricting individual freedom.

After the Great Depression, which had left many scars in the US society, it was a period when laissez-faire policies – policies that until the late 1920s had required relatively little governmental intervention in the market, and when laissez-faire thinking had been still dominant in many circles and in several countries – no longer seemed acceptable to an increasing number of economists and citizens. At the same time socialist economic planning was not considered a desirable alternative by most US economists.

A search was on, in those years, for a theoretically based, "normative" role of the state, a role that would recognize and respect the property rights of individuals and the work of the free market but that would also recognize and address the existence of market failures and the social needs of communities, as well as the special needs of individuals who faced temporary or permanent economic difficulties. It would be a new economic role that would be played by governments, guided by, presumably, *benevolent* and *competent* policymakers and implemented by efficient and honest bureaucrats. The new role would replace the very limited one that the state had played and had been expected to play in the past, and that in the United States had continued to be played in the 1950s by the Republican Eisenhower administration, in spite of the changes brought by the New Deal, when the laissez-faire, conservative thinking of earlier years had been challenged by the policies of the Franklin D. Roosevelt administration.

The work of most, though not all, of the aforementioned economists reflected an optimistic view that the government could do more and better than it had been doing in the past in the economic sphere, and that, with its action, it could improve the lives and the welfare of many citizens. Some of the aforementioned economists, especially Kenneth Arrow, had raised some fundamental questions about the difficulties that would need to be dealt with, if the government increased its economic role, to promote social welfare. The identification of what was the "public interest" or "social welfare" was a particularly difficult enterprise. Nevertheless, the optimistic view had become the prevailing view in Cambridge, Massachusetts, both at Harvard and at MIT. It was one of those times in history when different ideologies were colliding in the market of ideas and influencing the formulation of economic policies. This was also happening in Europe and especially in countries such as Sweden, France, the United Kingdom, Italy and several others.

The Eisenhower administration, which had been in power during much of the 1950s, had come under sharp criticism by an increasing number of economists for its conservative policies and for not doing more for the welfare of the citizens and the performance of the economy. As a convinced Keynesian (James Tobin) put it, in an article written in 1958, "Orthodox fiscal doctrines have … dominated our policies during the five years since 1953, and … have brought the nation to the brink of catastrophe" (published in Tobin, 1966, p. 57). He had added that "increased taxation is the price of growth" (ibid., p. 87), a statement that at that time would have been endorsed by many of the economists in the Boston area but that was challenged by others, especially at the University of Chicago. That view would continue to be challenged by more economists in future years, starting in the 1970s and would prevent in the USA the increase in the level of taxation that would characterize many other advanced countrues in future years.

I wrote my PhD dissertation under the supervision of Otto Eckstein (with Richard Musgrave as the second reader), on the impact of the individual income tax on economic growth in six major countries. A revised version of it was published as a book in the United States and in Japan and played some role in the supply-side revolution in the late 1970s, when it was cited by some proponents of that approach. After leaving Harvard, and for the following half-century, I continued to be interested in the question of the economic role of the state, while observing how that role, in the United States, other Western countries, including in Europe, and developing countries, was changing and generally growing.

In 1974, while a professor of economics in Washington, I took advantage of a sabbatical year and a research grant from the Bank of Italy to return to Italy. I spent a good part of a year reading the extensive Italian literature on the economic role of the state – literature that goes under the name of "Scienza delle Finanze" – and observing closely Italian economic developments when Italy was fast transforming itself into a welfare economy, at a time when the first oil crises hit the Western economies.

The Scienza delle Finanze is a particular school of thought developed by Italian economists, somewhat independently from the rest of the world, mainly in the period between 1850 and the 1930s, until the Fascist regime of Benito Mussolini made it more difficult for scholars to express views that did not coincide with those of the regime. Linguistic limitations had prevented that literature from influencing more than it did the English-language literature on public finance, the literature that would come to dominate the field of public finance in the decades after World War II. Richard Musgrave and Alan Peacock had reported some of that literature in a book they had edited in 1958, and James Buchanan played some role with his writings in bringing it to the attention of economists of what became the School of Public Choice.

The Scienza delle Finanze developed in a period that had not been an easy one for the Italian economy, and during which not all Italians had seen the government of the recently unified Italy as necessarily a benevolent one. In 1861, Italy had been unified and had created a national, legal entity from the aggregation of seven separate states that, until that time, had had different laws, different institutions, and, to a large extent, even different spoken languages. After it was unified, Italy had experienced some problems in some ways similar to those that the European Union and the European Monetary Union have been experiencing in recent years (see Tanzi, 2012, 2013a). Perhaps as a consequence of those difficulties, the Scienza delle Finanze had reflected a more realistic and more down-to-earth aspect compared with the Anglo-Saxon literature, which, until the School of Public Choice had come into existence, had seemed more detached from reality. A similar comparison could be made to the literature that had developed in Germany and in Scandinavia, where the state had been seen more often as a truer representative of the interests of the community.

The Italian School had developed during a period, and within a historical context, when the Italian government had not been seen as representing truly and fairly the whole community (see Tanzi, 2012). In an article published in 1958, James Buchanan, one of the founders of the School of Public Choice, after he had returned from a long visit to Italy and had been exposed to the Italian School, had written that the Italian Scienza delle Finanze had been an "eye opener" for him, and had significantly influenced his thinking on the economic role of the state. Through the work of Buchanan, and to a lesser extent that of Richard Musgrave and Alan Peacock, the Scienza delle Finanze had had some influence on the development of the School of Public Choice (see Buchanan, 1960; Tanzi, 2000b, chapter 1).

The sabbatical year that I spent in Italy in 1974 coincided with the beginning of the oil crisis, which required some governmental response, especially in a country, such as Italy, that imported all of the petroleum it consumed. The policies the Italian government adopted at that time influenced my thinking and helped create some initial skepticism about the simplistic and then fashionable view, held by many, of Keynesian, countercyclical policy, a view that many Italian economists were pushing, as well as about some aspects of an activist government's policies. At that time the Italian government was in the process of creating a public health system and other welfare programs that would require much more public spending and was dramatically increasing taxes and creating large fiscal deficits. Those policies would lead to the creation of a large public debt that in future years would become a permanent weight on the Italian economy and a continuous worry for future Italian governments.

The solution to the economic crisis that had been created by the sharp increase in the price of petroleum, and which many economists were recommending at that time, was to increase government spending, especially for investment, even though the crisis was clearly structural in nature and caused not by a fall in aggregate demand, but rather by a fall in aggregate *disposable* income. The increase in the price of an important import, petroleum, had obviously made the Italian population, and the populations of other countries in similar conditions, poorer. It had acted in the same way as would have acted a heavy tax on the economy to be paid to foreigners. It seemed strange to argue that such a problem could be solved, or alleviated, by higher public spending. It should not have been surprising when the higher public spending led to high fiscal deficits and to higher inflation, in Italy and in several other countries at that time, and not to the expected higher economic activity.

When I returned to Washington, after the sabbatical year in Italy, I accepted an invitation to join the IMF as head of the Tax Policy Division, one of the important divisions in the Fiscal Affairs Department of the IMF. I went to the IMF, on leave from my university position, on a two-year contract, but ended up spending the next twenty-seven years working for that organization and dealing with government policies in all parts of the world. Twenty of those years were spent as director of the Fiscal Affairs Department, a department that had the largest concentration in one place in the world of professional economists specialized in public economics.

The positions that I occupied at the IMF gave me a privileged vantage point for observing directly how different governments operated around the world, and how different economies reacted to various policies, including those that increased public spending. It also allowed me to check how the actual actions of governments and the reactions to them were consistent with the theories that public finance economists had developed and continued to develop over the years about how governments operated and how economies reacted to their actions. These were invaluable lessons that complemented the previously acquired academic knowledge.

Over a long and active professional career that has stretched for more than a half-century, I published many books and hundreds of articles dealing in various ways with the economic role of the state, and worked in many different countries, either developed, developing, or in transition, on issues related to what governments do. In 2013, I published a book and in 2015 some articles on the ongoing debate, in the United States and in European countries, on whether, in order to deal with the recession that followed the financial crisis, the governments should adopt policies aimed at what was called *growth* or *austerity*, and on how governments had reacted, or should have reacted, to the crises that affected many countries (see Tanzi, 2013, 2015a, 2015d). That debate reminded me of the ones I had observed in 1974, in Italy, and again in 1997–1999, during the financial crisis in Southeast Asia (see Tanzi, 2008a).

After leaving the IMF at the end of 2000, and after spending a couple of years in the Italian government, at ministerial rank, I had more discretion in the use of my time. In the years that followed, I spent increasing amounts of time reading or, in some cases, rereading and meditating over some of the classic works on the economic role of the state, and especially on works that presented different perspectives on what governments, or states, should do in their economic roles. These works included the writings of Adam Smith and of other famous philosophers and political scientists of the past, such as Thomas Hobbes, John Locke, J. J. Rousseau, Edmund Burke, and Alexis de Tocqueville, and also of classical French economists of the nineteenth century, as well as more recent works by F. A. Hayek, John Maynard Keynes, Richard Musgrave, Milton Friedman, James Buchanan, Kenneth Arrow, Amartya Sen, Robert Nozick, and others.

The aforementioned works were always illuminating, but I had the feeling that today's world had become different from that of the past, especially, but not only, because of the growth in the frequency and importance of negative externalities, and because of the impact of globalization and new technological developments on economic activities and on the power of national states. National governments have continued to try to control well-defined territories, while the borders of those territories have become much more porous to peoples, money, pollution, and various other, not always legitimate, activities. Urbanization has also created government functions that had attracted less attention in the past, when the need for those functions had not existed, or had not been felt as much.

As mentioned earlier, my long professional career, concentrated mostly on aspects of public economics, had required working closely and frequently with different kinds of governments around the world. This experience had given me an unusually broad perspective and an experience rarely found among economists, to consider some of the questions of what governments should do in the economies of their countries, how well they do it, and what obstacles and difficulties they encounter or can encounter in their actions.

In addition to the academic training acquired in a top graduate school, where I had had the fortune of working with some of the best minds in economics at that time, I had taught graduate courses in income theory and in public finance for about ten years, before benefiting from the twenty-seven years all spent in senior positions at the IMF. After leaving the IMF, I spent two years, 2001–2003, in the Italian government, as Undersecretary for Economy and Finance. These two years allowed me to observe, *from the inside* (as opposed to from the outside, as I had done in previous years), the messy ways in which policies are made and implemented by public sectors that tend to be far more fragmented than economists assume them to be (see Tanzi, 2015a, for a description of that experience). This experience made me appreciate the famous maxim that "if you want to continue to eat sausages, you better never go to the room where they are made."

In conclusion, unlike most of those who write about the economic role of the state or of the governments, I have had the chance of not only appreciating and enjoying the theorizing by academic economists, about what governments should or should not do in the economic sphere, and of telling governments, from outside, what they should or should not do, but also of observing closely, *from the inside*, what they actually do.

While I have remained convinced that a reasonably well-functioning government is essential and can be a force for the good, and a necessary condition for the welfare of communities and citizens, as Adam Smith believed, with the passing of time, I had become more aware than I had been earlier about the difficulties and the pressures that governments face, especially when their economic roles become too ambitious, and when they deal with economies that have become more complex, as most modern economies have become. These pressures inevitably distort their role from the optimal path that they should follow or may wish to follow. Complexity often ends up damaging the role of governments, perhaps more than economists realize. The more complex that role becomes, the less likely it is that it will remain optimal.

I also became more aware of problems that develop *within* the public sectors, problems that can reduce (at times by a great deal) the effectiveness of governmental actions. Many public finance scholars seem to have a *unitary* and centralized view of the public sector (see Tanzi, 2006a). They believe that there is a nerve center where all or the most important decisions are made and, once made, those decisions are smoothly and clearly transmitted to those who must carry them out. However, even in countries that do not have a federal structure, the public sector is made up of many components that do not always operate in a harmonious way, as would a good orchestra under the guidance of a good conductor. Ron Suskind's 2011 book, *Confidence Men*, provided some interesting information on this issue within the early years of the Obama administration. The more actors there are within an administration, the greater the likelihood that problems among the principal agents will develop, and the greater will become the difficulties and the lack of harmony within the government's operations.

Some difficult problems originate outside the governments that would make the work of *any* government difficult. Other problems develop inside the governments and inside the broader public sectors. The relevance and the severity of the problems change with time, and tend to vary in different countries. However, there are similarities in these developments. This book tries to highlight some of them. The problems depend to some extent on how ambitious the role becomes that governments attempt to play, and on the choice of the instruments used. The greater and more ambitious the role, the more likely it is that complexity will grow, creating unanticipated problems.

In recent years, in most countries, both the problems and the difficulties of solving them seem to have grown, making an observer more pessimistic about the future, and more skeptical about some of the simplistic solutions that one hears from both economists and politicians.

This book has tried to avoid what could be called the trap of *current, fashionable thinking*. It is easy to fall into the trap that is created when the most recent writing is assumed to reflect the final word on a topic, a word that is believed to incorporate and to be built on all the knowledge accumulated in the past. This assumption of a perfect market of ideas and of progress in thinking may be realistic in science. It is not often realistic in economics. If one believes in an efficient market for ideas or knowledge, one may feel that it is a waste of time to read anything that is more than a few years old. Many economists today feel that way, and some read only the latest articles in good economic journals.

However, as Gunnar Myrdal wrote in a brilliant essay first published in 1929, "we cannot pretend to understand completely, or even to define logically, the economic-political speculation of recent times except in the perspective of historical evolution" (p. x). Myrdal pointed out that in economics "the number of authentically recognized general truths is … very small" (ibid., p. xiii). And, he added, while in science the "warfare of ideas usually leads to some definite result," "in economics *all* doctrines live on persistently. No new theories ever completely supplant the old" (ibid., p. xiv; italics in the original). Under the influence of Myrdal, I have made a special effort in this book to place the issues discussed within their broad historical contexts.

The book covers various areas not covered by other books. It provides arguably the most detailed anatomy of the public sector available, and it does so while avoiding the use of unnecessary technicalities, to make the book accessible not only to economists but also to individuals from other disciplines and even to the educated public. The terms *state*, *government*, and *public sector*, in most cases, have been used as synonyms, although, of course, one could attribute to each of them precise, individual meanings. The terms have been used in their precise, individual meanings only when necessary.

Finally, the book is divided in three distinct parts, each interesting in its own way. The first part, consisting of nine chapters, provides a description of how the basic economic ideology that guided governments' actions in their economic role changed during the course of the twentieth century.