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The future of fiscal federalism ☆

Vito Tanzi *

Fiscal Affairs Department, IMF, Washington DC, USA
Economy and Finance, Italian Government, Rome, Italy

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ABSTRACT

For at least three decades after World War II, there was little interest in fiscal decentralization. Because of the large growth in public spending that took place during that period, a growth that was mainly focused at the central government level, this was a period characterized by fiscal centralization in most countries. Starting in the late 1970s, a reaction against large governments started. This reaction followed two distinct tracks: privatization and fiscal decentralization. The paper argues that these two tracks were almost two sides of the same coin and were largely mutually exclusive. They reflected similar concerns and objectives. In more recent decades, globalization has been creating global public goods or public "bads" and international activities that would require public attention or the action of a "world government". Because no such government exists, its role is progressively being delegated to proxies, in the form of international organizations, agreements, treaties, accords and other forms of international understandings. The paper concludes that this development is likely to weaken over time the role of central governments. It also speculates that it may strengthen the importance of municipalities.

1. Fiscal federalism and the welfare state

To predict the future it is always useful to study the past. The past can help us understand how the world evolved and might suggest possible developments for the future. However, the past must be considered a reference point, or a marker, and not an anchor. To see the future as the mirror image of the past is to ignore that progress and evolution always imply change.

For an academic discussion of fiscal federalism and fiscal decentralization in general there is no better place to start than Richard Musgrave's *The Theory of Public Finance*, a book written in 1959 that became an essential reference, for almost half a century, for students of public finance. In his comprehensive book of 628 pages, that covered in detail most topics in public finance, Musgrave allocated a miserly total of three pages (pages 179–182) to what he called "multilevel finance". For him this was a marginal or even trivial topic. Considering the attention that fiscal federalism receives today, this lack of attention on his part is remarkable. Why such limited attention? The answer is that this was not an omission but a reflection of the reality at that time.

Consider Musgrave's three basic governmental functions placing them in their historical context. In 1959 the Keynesian revolution was raging and had become popular among many economists, though there was still strong political and some academic resistance. Stabilization of the economy, as an explicit governmental objective, was a relatively new concept and, as Musgrave put it, "must be performed largely at the central level" (p. 181). It "requires central action" (Musgrave, 1959). Today, this view still prevails, even though there is greater skepticism than in Musgrave's time about a government's ability to play a successful stabilization role. See, for example, Tanzi (2007a,b).

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* Fiscal Affairs Department, IMF, Washington DC, USA.
E-mail address: vitotanzi@msn.com.

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What about distribution? There are two faces of income distribution, even though they are often confused: a traditional one and a more recent one. The traditional one was essentially the obligation of governments, or of quasi-public associations, to provide assistance to the *very* poor.[1] It had nothing to do with Gini coefficients or similar measures of income distribution. The obligation to assist the very poor had been recognized for a long time and, beside the role played by religious groups and by associations of mutual assistance or other charitable groups, *local* governments had often assumed the leading role.[2] They and the parishes were the ones who had the needed information as to who truly needed assistance at a given time. They also had more interest in dealing with this problem because of the negative consequences for cities of having the very poor in their midst. The negative externalities created by the existence of poor people were clearly recognized.[3]

However, half century ago, many industrial countries started the move toward the creation of "welfare states" in which national governments would assure to the population minimum levels of particular public services. Social protection "from the cradle to the grave" became a goal for many governments. Redistribution that often meant improving Gini coefficients became an objective distinctive from that of helping the poor. The thinking of the time, reflected in Musgrave's book, made it clear that this social protection was a *national* responsibility expressed in what came to be seen as citizens' entitlements. This responsibility could not be fragmented among (or delegated to) sub-national governments because minimum standards were set nationally and because the welfare state was expansive and could be financed only or mainly by national taxes. It is no coincidence that this was the time when the progressive income tax and the value added tax became the main sources of revenue in industrial countries. See Tanzi (2006a). These taxes perform well when they are national taxes but less well when they become sub-national taxes.

The creation of the welfare state led to an expansion of the power and economic role of the central governments over that of the sub-national or local governments. This was a period of fiscal centralization. Historical developments largely explain Musgrave's view that "the final distribution [of income] will conform with what is considered proper *at the central level*" (p. 181). Italics added. For this reason Gini coefficients became important statistics.

The third main government function, allocation, at least when it deals with genuine "public goods" – such as national defense, the establishment of national physical and institutional infrastructure, the provision of justice, the protection of property, the enforcement of contracts and so on – is almost inevitably a national function. Sub-national governments would under-provide, or not provide at all, public goods that would benefit the whole community.

At the time when Musgrave published his treatise, the cold war between the West and the Soviet Union was in full swing. 1959 was the year when the Soviet Union put Sputnik into space. The cold war divided the world into two competing camps. As a consequence there was, then, little interest in international cooperation and in creating supranational or truly global institutions, with strong powers, as there had been, briefly, immediately after World War II when the Bretton Woods institutions had been created, the United Nations had been expected to play an important role, and philosophers and political figures, such as Jacques Maritain, Albert Einstein, Winston Churchill, Bertrand Russel, Mahatma Gandhi and others, were pushing for the creation of a federal world government that would be responsible for dealing with global needs. According to Wikipedia, the free encyclopedia, "the years between the conclusion of World War II and 1950… were the "golden age" of the world federalist movement." In that period opinion polls in several countries found that a world government was favored by majority of respondents. These countries did not, however, include the United States. The newly created United Nations and the Bretton Woods institutions could have been the seed for this ambitious project.

In 1959 the European Union was still a distant dream even though the Treaties of Rome, signed in 1957, had established the European Economic Community; the World Trade Organization did not exist; and the powers of the existing international institutions were limited and focused on specific areas. Also international agreements and treaties that would later become common for groups of countries – on trade, taxes and other areas, and on regulations concerning the international activities of particular industries, such as the airlines, the shipping industry, the financial market, and others – were in their infancy. The countries' economies were still too closed (with respect to the exchange of goods and services and the movement of financial capital and workers) for governments to be much interested in these agreements. In this period the role and power of *national* governments became most prominent.

The great expansion of the national government's economic role after World War Two that led to a large increase in the share of public spending and taxes in GDP in most industrial countries,[4] did not and could not, displace completely the functions of local or sub-national governments. In several important countries – such as the United States, Germany, Brazil, India, Canada, Argentina, Switzerland, and others – intermediate, sub-national governments (states, länders, regions, provinces) had a historical origin: they had already existed in some form at the time of the creation of the larger national political entities. Thus, for them, the creation of national governments had been an act of *fiscal centralization*. Some of these intermediate sub-national governments had strong political powers given to them by the countries' constitutions. And some were as large as many countries. These powers essentially reflected *political contracts* between the regions and the national governments, contracts agreed at the time of the countries' creation. These powers were not derived from decisions of the national governments. The existence of these "federal"

[1] For example, in seventeenth century France "The principle was long established that each parish was responsible for its poor". See Solomon (1972), p. 22.
[2] See Aikema and Meijers (1989), and Zamagni (2000), and Solomon (1972).
[3] As Solomon (1972) writes: "The primary question facing town councils all over Europe was not the Eradication of Poverty…but rather how to protect themselves against…armies of poor." p. 24.
[4] For statistical evidence of that expansion see Tanzi and Schuknecht (2000).