European Journal of Political Economy 25 (2009) 133–136

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

Discussion

The future of fiscal federalism and the need for global government: A response to Vito Tanzi

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ARTICLE INFO

Article history:
Received 1 September 2008
Revised 2 September 2008
Accepted 3 September 2008
Available online 7 September 2008

JEL classifications:
F02
F53
F59
H11

Keywords:
Global government
International organizations
Fiscal federalism

ABSTRACT

Vito Tanzi [Tanzi, V., 2008. The future of fiscal federalism. European Journal of Political Economy 24, 705-712] makes a case for global government. This comment reconsiders the merits of global government as advocated by Tanzi.

1. A global government?

It is sad that Vito Tanzi, who has been very concerned about the rapid growth of government (Tanzi, 2000; Tanzi and Schuknecht, 2000), should plead for establishing a global government or, if this is not possible, for giving much more power to international organizations. Does he not see that international organizations are part of big government and that the centralization of policy making at the global level gives the state more power over the citizens?

Tanzi argues as if the state, as we know it, dealt exclusively with public goods or externalities. They motivate his proposals:

> "When they become global, they would justify the role of a *global* government *if it existed*… It is not too farfetched to assume that the globalizing world would need a global government (or a proxy for one) in the same way in which governments were needed in nations… The obvious political obstacles to it do not diminish the theoretical need for it. The normative case for a global government is strong" (pp. 709f.).

A global or world government would be extremely powerful. Would it — like a real government — have a police force or army at its disposal? Tanzi's externality arguments imply such a solution. How can such a concentration of power be kept in bounds? Who would command a majority in the general assembly of a world government? The historical experience of federal states shows very clearly how, gradually but inexorably, the centre expands and finally dominates the rest. Unlike existing federal states, a world government would not even be constrained by external competitors.

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doi:10.1016/j.ejpoleco.2008.09.001

2. International organizations

If it turned out that a global government cannot be established, Tanzi would content himself with delegating more power to international organizations. In this case, much depends on institutional detail. Power is less concentrated if the international organizations are specialized agencies rather than multi-functional organizations (like the European Union), if the international organizations are confined to regions, competing with similar institutions in other parts of the world and if decisions in these organizations are taken unanimously or do not bind the minority.

However, even if these conditions are met, the centralization of policy making tends to restrain competition among governments and create well-known principal-agent problems.

2.1. International organizations give the state more power over the citizens

A large body of literature, starting with Hume, Montesquieu, Ferguson, Smith, Turgot and Kant, has developed the basic insight that competition among governments or jurisdictions is needed to limit the power of the state and enlarge the scope for comparisons and innovation.[1] Competition among governments lowers the citizen's cost of informing and protecting himself. He can compare the performance of government in his and in neighboring countries (yardstick competition), and he can more easily leave the jurisdiction or export his capital (exit). Inefficient policy makers are deserted and voted out of office. Not so worldwide public institutions. Many of them can be viewed as international cartels of governments, and a global government would be a world monopolist. To summarize this literature, which Tanzi ignores, the centralization of policy making undermines individual freedom, democracy and efficiency.

The extent to which international organizations have these detrimental effects depends on their field of competence. If the international organization prevents the national governments from restricting trade and capital movements, as the WTO and the European internal market do, it does not centralize government intervention but eliminates it. It does not restrain but restore freedom. The same is true for international organizations that protect property rights — Tanzi mentions patent rights and the fight against international crime.

By contrast, freedom is clearly endangered if the international organization centralizes or “harmonizes” taxation and regulation. For instance, the European Union sets minimum tax rates for the value-added tax and some fuel taxes. But its main policy instrument is regulation (of labor markets, financial markets, product quality, etc.). Some even call this “regulatory federalism” and the EU a “regulatory state” (e.g., Majone 1996). Another outstanding example of a market-regulating international organization is the International Labor Organization.

Vito Tanzi expressly demands a much larger role of international organizations in taxation and regulation. He proposes to establish a “World Tax Organization” and increase the global regulation of financial markets. Moreover, he pleads for “expanding the reach” of the European Union including its regulatory activity (p. 709).

If decisions are not taken unanimously and collusively but by (qualified?) majority, the threat to freedom is even greater. In this case, the majority of highly taxed and regulated member states have an incentive to impose their high level of taxation and regulation on the minority of more liberal member states in order to weaken the latter's competitiveness. In the literature, this is called the “strategy of raising rivals' costs”. It can be observed in federal states[2] but also in international organizations.

The regulation of labor markets by the European Union and the International Labor Organization (ILO) fits this pattern.[3] In the field of taxation, the “Droit de Suite Directive” of the European Union (2001) provides a good example. It obliges the member states to impose a levy on art sales. The proceeds go to the artists and their often distant heirs. The directive was promoted by France and a majority of member states that had already introduced the levy, with the aim of weakening the competing art markets in London, Maastricht and Vienna, which had not been subject to the levy. The best known examples of EU labor-market regulations that have been challenged without success by the less regulated member states are the Working Time Directive (1993), the European Works Councils Directive (1994), the Information and Consultation Directive (2002), and the Temporary Workers Directive (2008). With regard to financial and product markets, regulations like the Financial Services Directive (2003) and the chemicals directive REACH (2005) are cases in point.

The probability that government representatives vote in favour of an ILO convention is significantly higher for countries with tightly regulated labor markets if, and only if, the convention is of the cost-raising type.

Does Tanzi also wish to enlarge those international organizations that grant transfers or subsidized loans to governments, interest groups or citizens of the member states? The most prominent examples are the World Bank, the International Monetary Fund and the European Union — many others could be added. There is mounting evidence that their activities tend to encourage rent seeking, moral hazard and political business cycles.[4] To some extent, their transfers — at least the marginal ones — seem to do more harm than good. The international tax cartel by which they are financed may raise more money for transfers than the tax paying donors may wish.

[1] For a survey of this classical and the more recent literature see Vaubel (2008a).

[2] For a number of case studies see Bernholz and Vaubel (2007).

[3] For the evidence and a formal game-theoretic analysis see Vaubel (2008b) and Boockmann and Vaubel (in press). However, note that ILO conventions do not enter into force unless they are ratified by the member states.

[4] With regard to moral hazard and the electoral cycle, Dreher and Vaubel (2004) present econometric evidence.

2.2. International coordination of demand management?

Vito Tanzi (p. 710) puts much emphasis on the need for "coordinating demand management", that is, monetary and fiscal policies. He believes (p. 709) that interest rates, for example, "have become global concerns… requiring again a coordinating role on the part of some international organization (the IMF?)". As a matter of principle, such international "spillovers" are not externalities in the welfare-theoretic sense but merely instances of international interdependence through the market, i.e., the price mechanism. In well-functioning markets, such spillovers are "merely pecuniary": interdependence through markets does not preclude Pareto-optimality — quite the contrary, it brings it about. Hence, it is not true that the rapid decline of international information and transaction costs and the resulting increase in international market integration *as such* cause a (growing) need for international policy coordination. To the extent to which markets become more competitive, the need for government intervention even declines.

Some game theorists construe an exception to this general result by assuming that governments choose to have more targets than instruments. Under these conditions, the Nash equilibrium is not Pareto-optimal and coordination along the contract curve would generate a Pareto-improvement — provided that the disadvantages of policy collusion are ignored.

However, the first-best solution is not to have more targets than instruments. Such a system is intransparent for the citizens and generates political risks because it is not possible to predict the point on the contract curve that the governments will choose. If, on the other hand, each government has as many instruments as it has targets and assigns each instrument to one target according to its comparative advantage, the resulting Nash equilibrium is Pareto-optimal.[5]

The assignment solution permits an efficient division of labor among policy makers. Each policy maker or institution can specialize on the use of his instrument with respect to one target variable. Moreover, the assignment solution permits effective democratic control. The citizens understand which policy maker is responsible for which target. Without clear responsibility, the causes of policy failures will remain obscure and a corrective feedback mechanism will be lacking. Finally, the decentralization of monetary and fiscal policies is a way of diversifying policy shocks — it stabilizes the world business cycle.

The international coordination of monetary policy raises two additional problems. Money is not a public good — it satisfies neither the non-excludability nor the non-rivalness criterion. The choice of currency may generate network externalities and money may be a global natural-monopoly good — but then currency competition should destroy itself, which, historically, has not been the case. Competition among the suppliers of money — i.e., non-coordination — provides two important benefits.

First, it limits inflation because each central bank has to be afraid that an excessively expansionary monetary policy would lead to (expectations of) depreciation, outward currency substitution, and capital flight. These market reactions would aggravate inflationary pressure and reduce the central bank's market share and monetary policy power. A large body of theoretical and empirical literature develops this insight, which is due to Hayek (1976).

Second, in the absence of monetary policy coordination, the threat of depreciation, currency substitution, and capital flight serve to strengthen the credibility of central banks. As Rogoff (1985) was the first to point out, non-coordination helps to overcome the well-known time-inconsistency problem. Kehoe (1987) has extended this argument to taxation.

Tanzi, by contrast, wants to restrain currency substitution, and raise global government revenue, by the Tobin tax (p. 709). However, since short-term exchange-rate fluctuations are mainly due to new information, i.e., random shocks that affect the exchange-rate expectations of domestic residents and foreigners alike, short-term exchange-rate volatility is hardly associated with capital movements. The taxation of capital movements would impede the efficient allocation of the world capital shock rather than reduce exchange-rate fluctuations.

2.3. International public goods and network externalities

This leaves us with a few genuine international public goods and network externalities. Tanzi mentions cross-border pollution, epidemic diseases, research, and transportation. This is a far cry from the need for "global government". When the group of affected countries is small and bargaining costs are low, even Coasian contracts might suffice. Cross-border transportation and the pollution of border-crossing rivers are cases in point.

If basic research is to be subsidized, this is essentially the task of those countries that can do basic research, i.e., the industrial countries. It would be a matter for the OECD — not global government. I assume that the subsidy would be paid across the board to all basic researchers; for whoever tries to pick the winners — as the European Commission does — pretends to possess a knowledge that no none can have.

2.4. The agency problems of international organizations

Whatever an international organization does, there are serious principal-agent problems. These are more severe for international organizations than for national governments. International organizations are farther removed from the attention and control of citizens and voters than the national, provincial and local governments are. This is due to the longer chain of delegation but also to sheer distance, language problems, and absence of bureaucratic transparency, which increase citizens' information costs and diminish their incentives to be informed. The international agents have interests of their own: more staff, a larger budget, and

[5] For theoretical demonstrations of these points see Patrick (1973) and Oudiz (1988).

more competencies. The members of the European Parliament, for instance, prefer far more competencies for the European Union than the citizens do (see Schmitt, Thomassen 1999, Table 3.1). International bureaucracies use their resources to further their aims. This centralizing dynamic is hard to stop. As Gottfried Haberler (1974: 156) once noted, "international institutions may change their names or lose their function but they never die". There are not many exceptions to this rule.[6]

Owing to these agency problems, there is a trade-off between the internalization of international externalities and democratic control. It is not optimal to try to internalize every little externality, even if it is a genuine one. Tanzi knows some of these arguments. Somewhere else in the article, he mentions the existence of a literature that claims that fiscal decentralization "would increase citizens' control over the decisions of distant political leaders" (p. 708). Does he agree with it? If so, how does it in his view affect the desirability of a global government or centralized policy making by powerful international organizations?

3. Lessons from history

Finally, let history be our guide. Most economic historians have come to agree that the "European miracle" (Jones 1981) was due to political fragmentation. The enlightenment, modern science and the industrial revolution emerged in Europe — not in China, India or the Ottoman Empire, which, in the middle ages, had still been at a comparable level of development — because, in Europe, rulers had to compete for the mobile elites: merchants, scientists, artists and religious minorities like the Jews and Protestants. These mobile elites offered know-how, financial capital and taxable resources to their rulers. To attract them, the rulers granted economic, political and religious rights. They gave more freedom than they would otherwise have done and more than was granted elsewhere. True, there were many — sometimes terrible — wars but, in the long run, they could not prevent fragmented Europe from surpassing all other civilizations.

Perhaps the best example, and the greatest success, of interjurisdictional competition took place in Italy. When the German emperors loosened their grip on Northern Italy, fierce competition developed among the city states. It produced the miracle of the Italian Renaissance. Surprisingly, its causes do not seem to have been understood by Italian political thinkers at the time. Machiavelli, for one, was longing for the unification of Italy.

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FURTHER READING

Tanzi, V., 2008. The future of fiscal federalism. European Journal of Political Economy 24, 705–712.

[6] For a fuller account of these principal-agent problems and empirical analyses see Vaubel (2006) and Vaubel et al. (2007).