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Globalization and the Future of Social Protection

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Globalization and the Future of Social Protection[1]

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Abstract

Social protection in industrial countries has been provided through regulations, tax expenditures, and public spending. This paper argues that globalization will affect governments' ability to continue providing this social protection at the level of recent decades. Specifically, tax competition among jurisdictions, ballooning electronic commerce, and increased mobility of the factors of production will likely cause significant falls in tax revenue in future years. The paper concludes that the welfare states need to look for alternative ways to provide social protection.

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Contents

I. Introduction

It is a general perception that in recent years the world has been changing rapidly and that it is likely to keep changing in future years. In the introduction to his latest book, Bill Gates predicts that: "Business is going to change more in the next ten years than in the last fifty." See Gates (1999) p. XIV. He adds that "These changes will occur because of a disarmingly simple idea: the flow of digital information." Ibid. Kenichi Ohmae has called attention to the globalization of the four Is, namely Investment, Industry, Information, and Individuals. As he points out, investment is no longer limited by geography; industry has gone global with the growing role of the multinationals and with the distribution of their productive capacities in several countries; information is more easily available through the internet and can be and is transferred cheaply and in real time from one part of the globe to another part; and individuals are less and less confined to the place where they were born and raised. See Ohmae (1995). The cost of travel, especially when expressed in terms of a person's income, has fallen dramatically thus encouraging many to visit other countries.

It can be argued that the present wave of globalization is nothing new. There have been periods in the past when trade and capital flows were growing rapidly and, as shares of GDP, for some countries, were as high as they are now; and when technological change and the fall in the obstacles to international transactions, such as transportation costs and the speed at which information could be transferred, provided a great stimulus to globalization.[2] And there were periods when large masses of immigrants moved across countries or continents. Yet, the important change at the present time is what Gates mentions in the above quotation, namely the trade in information and knowledge made possible by the information revolution and by the increasing market value of knowledge. This change has convinced many that we are experiencing a "new economy" characterized by much faster productivity gains. As it happened after the introduction of the railroad or of electricity, the information revolution might bring to the world a period of high and sustained growth.

Modern economies are much more knowledge based than past economies which were much more resource based. The capacity to access information and to transfer it cheaply and instantaneously to individuals who put a high value on that information and are willing to pay for it makes this period distinctive and opens many possibilities and some problems for the future. Some of the ongoing changes will subject the existing institutions, created under a different environment, and especially the tax systems and the systems of social protection, to significant stress. There is no question that these institutions will need to adjust to the new environment. Whether the adjustment will be smooth or difficult remains to be seen. It will depend largely on the vision and on the technical and political skills of those who make policy decisions.

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[2] For a fascinating and highly informative discussion of the wave of globalization that came to an end in 1914, see Baldwin and Martin (1999).

The changes that are occurring and that are likely to continue to occur in future years, as new technologies develop and as the available technologies and the existing trends spread to incorporate more and more countries and more and more people, will affect relative prices, jobs, income distributions, tax revenues, government expenditures, regulations, and other areas.

Because of the total impact of globalization:

The prices of some products will fall significantly while the prices of others will increase. These changes in relative prices will hurt some activities, some industries and some countries while they will help others.[3] As an example, it is unlikely that, in the absence of globalization, Finland would have benefited as much as it did from the development and the production of high quality cellular phones. At the same time, traditional industries will see jobs disappear thus leading to the kind of antagonism against globalization that was in evidence in Seattle during the 1999 meeting of the World Trade Organization.

Some groups of workers, and especially those with high technical aptitudes and skills, who can more easily adapt to new technologies, are likely to benefit. Just think of those who went to work for Microsoft or for Nokia two decades ago; or the workers in India doing computer programming for American companies![4] On the other hand, low skilled workers, unable to adjust to the new world, will be negatively affected.[5] Some writers and some labor union leaders have argued that globalization destroys jobs and is, thus, directly responsible for the growth in unemployment experienced by several countries and especially by European countries. Thus, they argue that all workers are likely to lose. See for example, Forrester (1996) for an emotional and articulate, though not convincing, statement of this thesis. These individuals do not recognize the job creating impact of globalization and the impact on productivity of the information revolution.[6]

Closely linked to the issue of the impact of globalization on relative wages, is its impact on income distribution within countries and across countries. Evidence reported by various

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[3] For a discussion of who gains and who loses from globalization see the papers by Lal and by Bhagwati in Horst Siebert, editor (1999).

[4] The lists of the world richest individuals published annually by Forbes magazine now include many individuals, some very young, who made their fortunes from these technological breakthroughs.

[5] There is now a large literature on this issue. Inter alias see the papers by Leamer and by Burda and Dluhosch in Siebert, editor, op.cit.

[6] Interestingly, the country that is the leader in the introduction of these new technologies, the United States, has seen its unemployment rate fall to the lowest level in several decades.

sources indicates that the income distribution of many countries has become more uneven in recent years and some economists have tried to establish links between this statistical trend and globalization. See for example, Atkinson (1999), Leamer (1999), and Haskel and Slaughter (1999). To the extent that globalization is a factor in the worsening of the income distribution of countries, and as long as one of the fundamental roles of the government is an improvement in the income distribution, a potential problem arises if globalization increases the need for governmental intervention while, at the same time, it reduces its capacity to intervene. The problem raised by a worsening of the income distribution across countries is even more difficult to solve in the absence of a world government and because of falling transfers to poor countries.

There is now a growing literature that points to the fragility of the existing tax systems in the face of the developing trends. See Tanzi (1995 and 1996). While the evidence of the quantitative impact of globalization on tax revenue is still limited, that evidence may not tell much about the future. It is likely that, as time passes, the impact of globalization on tax revenue will accelerate and will become quantitatively evident. The reasons for this statement will be discussed later. If globalization reduces tax revenue and the governments' ability to have tax systems that are progressive and equitable, the governments will lose a major instrument for promoting social protection. For sure, their ability to finance present levels of social spending will be reduced.

Globalization is also likely to reduce the ability of individual governments to impose regulations. For example, existing regulations of labor markets are likely to be affected as the need for more flexible labor markets becomes obvious. Regulations on capital movements and on other areas, such as foreign trade and financial and insurance markets are also likely to be influenced. This may impact a government's ability to promote social protection through regulatory activities.

Finally, the financial crises of the past few years, such as those in Mexico in 1994-95, in South East Asia in 1997-98, and in Brazil and Russia in 1998 have been blamed by some on the process of globalization. It has been argued that, through its impact on short term capital movements, globalization has increased the likelihood of financial crises. If globalization increases financial instability, it also increases the need for the government to pursue a greater stabilizing role in the economy than in the past. However, this greater need may not be accompanied by a greater ability to do so.

II. The Growth of Social Protection

The previous significant period of globalization that ended in 1914 with the First World War occurred in a world without governments systems of social protection. For the 1870-1913 period, for which we have data for many countries, the ratio of tax revenue and public spending in GDP was very low, by today's standards, and over that period it showed hardly any trend. For a group of 18 countries, including many of those now referred to as advanced countries, the share of tax revenue into GDP was on average about 11-13 percent over this 43 year period. See Tanzi and Schuknecht (1997).

The countries that are now considered welfare states had spending levels that in 1913 were close to the low tax average of that period. At that time public expenditure for education averaged about 0.6 percent of GDP for the whole group; public expenditure for health was only 0.3 percent of GDP; public expenditure for pensions was about 0.4 percent; and public expenditure for unemployment compensation and for other transfer programs was insignificant.[7]

After 1913, public spending started to grow as a consequence of changing social attitudes. Especially, after the Second World War many countries, and especially the European countries, developed systems of social protection that aimed at protecting citizens against risks associated with old age, illnesses, various forms of incapacity, unemployment, poverty due to particular situations such as becoming widows, orphans, or being part of large families. The growth in public spending occurred in periods when countries were still relatively closed. By the time globalization was in full swing, the systems of social protection had reached their maturity.[8]

Governments have tried to provide social assistance and protection through the use of three major instruments, namely, (a) public spending, (b) the tax system, and (c) the regulatory framework. Each of these instruments has been used to assist particular groups. To some extent each instrument has been preferred in particular countries at specific times. In some countries taxation has been the instrument of choice. In others, it has been regulations. In many countries it has been public spending. However, in most countries these three instruments have been all jointly used but in varying proportions. Thus, some countries have ended up with large public spending, others with high and much distorted tax systems, while still others have ended up with overregulated economies. A few have combined all these characteristics.

Figure 1 provides a simple, schematic view of the structure of the arguments presented in this paper. Social protection is seen to be influenced by the three instruments mentioned above and these instruments are in turn shown to be influenced by globalization. Thus, globalization affects social protection mainly through the impact that it has on the instruments available to the governments. Of course, to the extent that globalization changes social and government's attitudes towards social protection, it may have a direct impact not channeled through the instruments. This impact is not shown in the figure.

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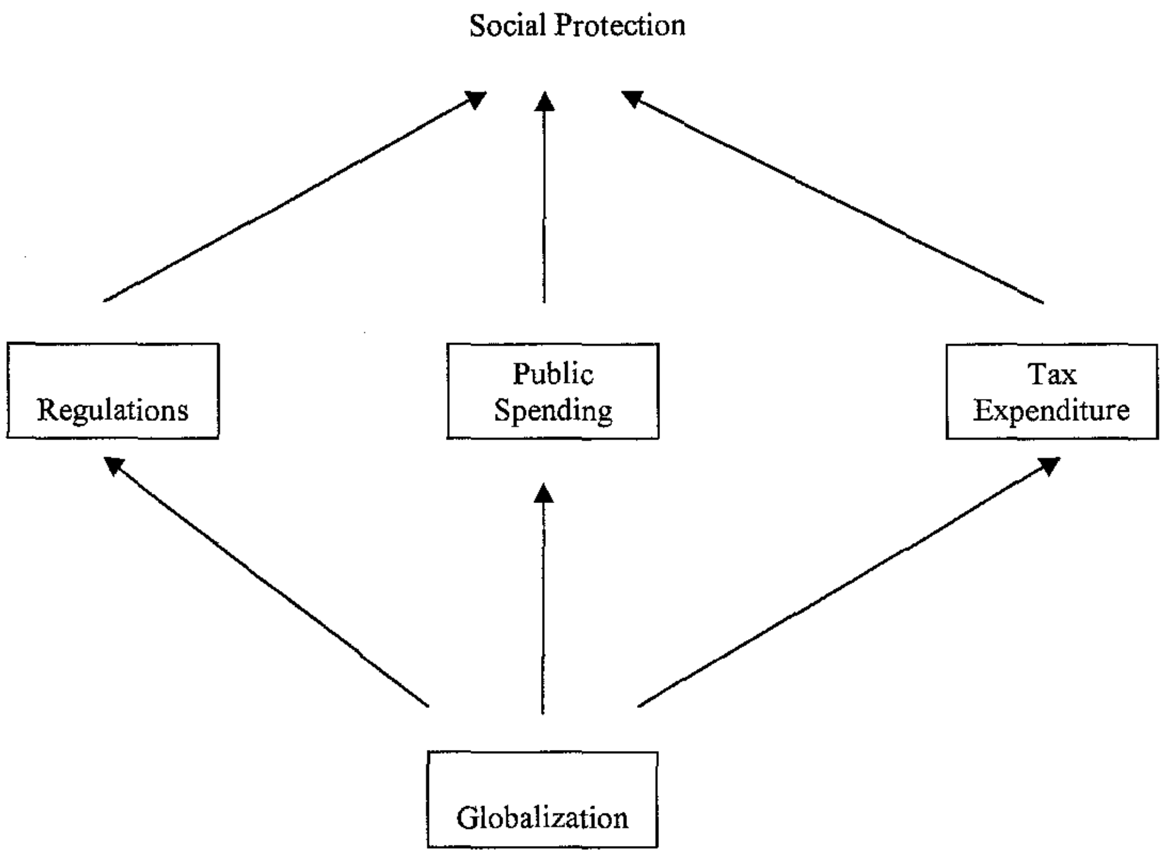
[7] Information on the growth of public spending in 18 advanced countries is available in Tanzi and Schuknecht (2000).

[8] For a good description of a mature social protection systems, see Ministry of Social Affairs and Health (Helsinki, 1999).

Figure 1

Impact of Globalization on the Instruments of Social Protection



III. The Growth in Social Spending

While public spending started rising during and after World War I, its growth remained modest until the 1950s.[9] Between 1960 and 1980 a large increase in public spending took place in all industrial countries but especially in the European countries. For 18 advanced countries combined for which information is available, average, unweighted public spending grew from about 28 percent of GDP in 1960 to about 43 percent of GDP in 1980. For the European countries in the group the increase was somewhat larger. If we focus our attention on public spending for subsidies and transfers in the European countries in the group, its share of GDP rose from 10.8 percent of GDP in 1960 to 24.0 percent of GDP in 1980. See Table 1. A large part of the increase in public spending was accounted for by increases in subsidies and transfers which were the basic ingredients of the welfare state.

Table 1 also shows that the rate of increase slowed down considerably in the period after 1980: the average grew by only 2.8 percent of GDP in the next 15 years compared with 13.2 percent of GDP in the previous 20 years. In non-European, advanced countries, the increase in the share of subsidies and transfers in GDP over the 1960-80 period was only half that of the European countries. Among the latter, the Netherlands, Sweden, France, and Belgium were the leaders with increases of 27 percent, 21 percent, 18.5 percent, and 17.3 percent of GDP respectively. The 1960-80 period saw the maturation if not the genesis of the welfare state. Country after country increased public spending in an attempt to reduce various risks. The risks of becoming illiterate, ill, old, or unemployed received particular attention and various public programs were developed or strengthened to deal with them. These programs often required public spending but, occasionally, some of them also relied on the use of other instruments such as tax expenditures and regulations.

Table 2 shows the contribution to the increase in public spending over the 1960-80 period accounted for by education, public health, public pensions, and unemployment compensation for a group of European countries. These four categories accounted for a large share of the total increase in public spending. Given the existing programs, public spending for health and pensions can be expected to continue growing because of demographic changes. Thus, these programs, if unchanged, will require growing public resources.

[9] However, by 1950 some economists and political scientists were already expressing concern about the growth of the welfare state. See, for example, de Jouvenel (1952).

Table 1
Government Expenditure on Subsidies and Transfers
(Percent of GDP)

	1960	1980	1995
France	11.4	24.6	29.9
Germany	13.5	16.8	19.4
Norway	12.1	27.0	27.0
Spain	1.0	12.9	25.7
United Kingdom	9.2	20.2	23.6
Austria	17.0	22.4	24.5
Belgium	12.7	30.0	28.8
Ireland	NA	26.9	24.8
Italy	14.1	26.0	29.3
Netherlands	11.5	38.5	35.9
Sweden	9.3	30.4	35.7
Switzerland	6.8	12.8	16.8
Average	10.8	24.0	26.8

Source: Adapted from table 11-4 of Tanzi and Schuknecht (2000).

Table 2
Increases in Categories of Public Spending in Subsidies and Transfers, 1960-80
(Percent of GDP)

	Education	Health	Pensions	Unemployment
France	2.6	3.6	4.5	1.3
Germany	1.8	3.3	3.1	0.8
Norway	3.0	3.9	3.8	0.0
United Kingdom	1.3	1.9	1.9	0.7
Austria	2.7	1.4	1.8	0.1
Belgium	1.5	3.0	6.9	1.9
Ireland	3.6	5.4	3.3	1.4
Italy	0.8	3.0	6.2	0.3
Netherlands	2.7	5.2	8.6	0.4
Sweden	3.9	5.4	4.5	0.2
Switzerland	1.9	3.4	6.2	0.1
Average	2.3	3.6	4.6	0.7

Source: Adapted from several tables in Tanzi and Schuknecht (2000).

IV. The Use of Tax Systems and Regulations for Social Protection

A. Tax expenditures

While public spending has been the preferred or the most obvious instrument for providing social protection to the majority of the population and most economists associate the welfare state with that spending, the structure of the tax system has also played a significant role especially in some countries. This role is additional to the one that the tax systems have played through their financing of public expenditure in ways that did not lead to inflation or to excessive increases in public debt. The tax systems were often used to support certain socially desirable activities through the provision of "tax expenditures."[10] These tax expenditures became especially significant in Anglo Saxon countries which showed more resistance to large increases in public spending.

Tax expenditures are implicit incentives to specific activities given through the tax system. Up to a point they may substitute for, or be equivalent to, public spending in the government's pursuit of particular objectives. For example, a government that wants to stimulate education can (a) spend more money on it so as to lower its cost for the students or their families; (b) subsidize the students through vouchers or through other means; or (c) allow the students or, more often, their parents to take a deduction from their taxable incomes for money spent for tuition, textbooks or other school-related activities. The value of the tax expenditure to those who benefit from it depends on the level of the statutory tax rates. Given that in the period after World War II tax rates became very high in the majority of industrial countries, the value of tax expenditures became also very high for many taxpayers. The personal income tax became the instrument of choice for this kind of social engineering. As a consequence, in some countries, this tax became very complex as more and more social objectives were pursued through tax deductions against taxable income, that is through tax expenditures.[11]

The tax systems of many countries have been characterized by various tax expenditures provided in support of socially desirable objectives. For example, in some countries, some educational expenditures have been allowed to be deducted from taxable incomes and these expenditures have also been exempted from indirect taxes. Some health expenditures have received similar treatment in addition to the fact that the implicit income value of health benefits has not been taxed. Pensions have received favorable treatment either because the pensions received by the pensioners, or the earnings of pension funds, have not been taxed; or because the contributions to pension schemes by the individuals or their employers have

[10] The concept of tax expenditure was developed in the United States in the 1960s.

[11] In some countries other taxes such as the value-added tax, social security taxes, and property taxes were also adapted to the particular situation of the individuals or even of regions.

been exempt. Furthermore, individuals with particular disabilities or particular conditions, such as blindness or other handicaps or simply old age, have received some tax advantages such as, for example, double personal exemptions in the United States or reductions in the property tax liabilities. Large families have been often advantaged by particular provisions in the laws and working families with low incomes have received special deductions, such as earned income credits.

It is likely that there have been some tradeoffs between the use of tax expenditures and direct social spending in the sense that a larger use of tax expenditures by a country may have been accompanied by lower direct social expenditure. Unfortunately, the data requirements needed to test this hypothesis are enormous so that it is difficult to test it empirically.[12]

In the late 1970s and early 1980s, especially in the Anglo Saxon countries, tax expenditures came under criticism because of their impact on the domestic playing field and on the nominal tax rates and because of the complexity that they brought to the tax systems. Major tax reforms were introduced in the United Kingdom, New Zealand, the United States, Australia, and a few other countries during the decade of the 1980s. These reforms aimed at reducing tax expenditures and tax incentives in general and at widening tax bases thus permitting a reduction in the statutory tax rates. Because of the reduction of the statutory rates, the value of the remaining tax expenditures was also reduced. These reforms represented an indirect attach on the welfare state by conservative governments.[13]

B. Regulations

Many countries have pursued their social objectives not through public spending or tax expenditures but through regulations. In fact, one could almost identify regulatory welfare states. To understand this concept, it is necessary to recognize that, in their effects, many economic regulations can be equated to taxes, subsidies or, in some cases, to both. Through particular regulations, a government can, thus, subsidize some individuals and tax others without having to actually collect taxes or spend money, i.e., without any impact on the budget.

A good example is rent controls which implicitly subsidize those who are occupying rented houses while they tax the owners of these houses: when rent controls are imposed, the renters pay less rent; and the rentiers receive less rental income. Under the normal assumption that, on the average, the owners are richer than the renters, this policy represents, at least initially, a way of redistributing income. At least in theory, the government could get similar results by explicitly taxing the owners and explicitly subsidizing the renters. This, however, would

[12] For some earlier statistical evidence of this trade off see Tanzi (1968).

[13] In the United States where the 1986 tax reform reduced many of these tax expenditures, recent years have seen some reintroduction of them.

increase both the tax burden and the level of public spending. It is thus easy to see how regulations can be manipulated to become instruments for promoting some forms of social protection or for achieving other objectives.

Obviously, these regulations also reduce the efficiency of the economy. Furthermore, the long run impact of these regulations may be very different from the initial impact because incentives may be set in motion that over the years lead to different and unintended results or because the income levels of the affected individuals change. For example, rent controls may discourage the building of new houses or the renting of existing houses thus progressively reducing the supply of rental housing and increasing the rents paid by individuals with low incomes who do not already benefit from controlled rents. Additionally, regulations often lead to corruption.

Various forms of social protection have been promoted through the regulations of many areas such as labor markets, housing markets, financial markets, the market for (or better the access to) several public services, and through many other channels.

Labor markets have been distorted by regulations that make it difficult to fire workers, even when their performance is poor, that give hiring preference for particular individuals such as war veterans, handicapped, widows, orphans, unemployed, heads of families, or other individuals who are in situations which presumably require social protection. Also, at times, wage differentials have been artificially constrained in an attempt to improve the standard of living of low skilled workers.[14]

Housing markets have also been used to favor particular individuals by making it difficult to reclaim rented apartments subject to rent controls. Banks have been forced to provide subsidized loans for activities considered of high social value, as for example, to students or to individuals living in poorer regions; or public financial institutions have been set up to achieve similar objectives. Particular individuals have received preferential treatment (i.e., lower costs) in their consumption of electricity, gas, water, public transportation, health, education, and food. Public enterprises have occasionally been forced to continue providing services at high costs to poorer areas or poorer individuals for social reasons, or to retain workers that they no longer needed. Enterprises, both private and public, have been forced to provide various social services to their workers and their families or to the communities in which they operated.[15] Price controls have been used to implicitly subsidize poorer groups.

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[14] For example, "In Germany the lowest wage is 70 percent of the average wage; in the United States it is 30 percent" See Hans-Werner Sinn, 1999, The IFO Viewpoint (Institut für Wirtschaft-orschung).

[15] In the planned economies, especially, public enterprises were largely responsible for many social services which should have been provided by the government.

The use of regulations to promote social protection has received relatively little attention on the part of economists. Thus, there has been no analysis of which I am aware of what could be called a regulatory welfare state.[16] However, a general movement against many regulations started in the late Seventies and Eighties and, in attempts to increase the efficiency of the market, some regulations were reduced. As some of these regulations were connected with the existence and the activities of public enterprises, the movement toward privatization also played a role in their reduction.

Because of the need to improve competitiveness and because of international pressures on countries to conform with a developing, new architecture of the international financial system, the independence that the countries have had in the past to use regulations for domestic purposes will be curtailed in future years. In some areas the new architecture is likely to impose standard regulations or common norms.

If globalization affected the government's ability to raise high tax levels, to provide tax expenditures, or even to use regulations to achieve particular domestic objectives, it will inevitably have an impact on policies that, at least in intention, aim at social protection. It could be expected that if less protection is given through tax expenditures or through regulations, there will be more pressure to compensate with more public spending. However, if the government's ability to finance this spending is also reduced, some negative impact on traditional social protection will be inevitable.

V. General Impact of Globalization

The impact of globalization on the welfare state may come from various channels, some more general than others. It may come from the increasing competition that globalization brings about and thus from the need for more efficiency.[17] It may come from the increasing mobility of factors of production, especially financial capital and individuals with great ability. It may come from international pressures to level the regulatory playing field or to introduce uniform standards or codes of conduct. These channels are likely to become more important with the passing of time. Thus, effects that are barely noticeable now will become more visible later.

Globalization tends to raise the share of trade in gross domestic products and, as a consequence, to expose inefficient sectors or industries to greater foreign competition. Enterprises or workers that have operated behind the protection offered by high tariffs or by other protective policies may find themselves without such cover. This applies especially to

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[16] To a large extent centrally planned economies were extreme versions of regulatory welfare states.

[17] Globalization and especially the Internet provide much more timely information of prices and other relevant variables thus increasing competition.

public enterprises engaged in industrial protection. For some of the countries belonging to the European Union, the help that occasional devaluation had offered in the past is no longer available. In this swim or sink environment the need to become more efficient becomes obvious. But efficiency depends, in part, on the actions of the enterprises and of the workers themselves and in part on policies. A country that imposes high taxes or other constraints (say a very short work week) on its enterprises and workers puts them at a potential competitive disadvantage vis-à-vis enterprises that operate in different environments.

With globalization financial capital and high skilled or high talented individuals become much more mobile because their options expand to other countries. High taxes or too constraining regulations create strong incentives for them to move elsewhere. The loss of highly talented individuals and the outflow of financial capital can have a negative effect on the growth rate and on the tax revenue of a country. In an open world where foreign competitors face lower taxes and fewer constraining regulations, it becomes more difficult and more costly for a country to maintain high taxes and more regulations.

Globalization brings strong pressures on the international community to level the international field in which individuals and enterprises operate. Thus, existing rules about foreign trade, about the environment, about cultural and health related protection, about the operation of financial sectors, about transparency in fiscal accounts and in accounting standards in general, may need to be changed. The current ongoing discussion about remaking the architecture of the international financial system is, in a sense, a movement toward the leveling of the international playing field. In this environment it will become progressively more difficult for some countries to maintain the tax burdens necessary to sustain high levels of spending, or to continue to use regulations and tax expenditures to promote, through them, the current levels of social protection.

VI. Globalization, Tax Systems, and Fiscal Termites

While globalization may affect the existing welfare states in many different ways, the most direct and powerful impact will probably come through its effect on tax systems. There is now a growing literature on globalization and tax systems so that there is no need to repeat the arguments presented in that literature. See Tanzi (1995 and 1996). For the time being there is little, if any, evidence that the tax systems of the industrial countries are collapsing. On the contrary, for the majority of these countries the level of taxation is at a historical high. However, in most countries in recent years, the tax level has stopped growing and, in a few, there has actually been some decline. Furthermore, some finance ministers have been complaining about the effect of tax competition on the revenue of their countries and the OECD and the European Community have been concerned about various aspects of tax competition.

While the fiscal house is still standing and looks solid, one can visualize many fiscal termites that are busily gnawing at its foundations. These include:

a. Increased travel by individuals which allows them to shop, especially for expensive items, in places where sales taxes are lower. This creates incentives, especially for small countries, to reduce excises and other sales taxes on luxury products in order to attract foreign buyers.[18] This form of tax exporting and of tax competition will progressively reduce the degrees of freedom that countries have in imposing excise taxes on many high-priced products. In fact, revenue from excise taxes, especially if gasoline and tobacco products are excluded, has been falling rapidly in recent years;[19]

b. Increased activities on the part of some highly skilled individuals conducted outside of their countries which allows them to underreport or not to report at all their foreign earning; at the same time, more and more individuals are now investing their savings abroad in ways that allows them to underreport or even evade taxes. This has been a major concern on the part of the European Commission that has been advocating the use of minimum taxes on incomes from financial assets.

c. A growing use of electronic commerce and electronic transactions in general largely taking place outside of the tax system. Electronic commerce has been growing at very high rates and is expected to reach very high volumes within a few years. A large share of the world commerce, and especially that among enterprises, could soon be channeled through the Internet.

Electronic commerce is going to be a nightmare for the tax authorities.[20] This commerce is bringing with it some important changes.

The first change is that from real transactions, requiring papers which leave various traces for the tax authorities to follow, to virtual transactions which leave much less identifiable traces. If origin-based taxation should prevail, sales establishments would choose to locate themselves in places where there are low or no sales taxes. But destination-based taxation may be very difficult to implement especially in a world set to facilitate foreign trade.[21]

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[18] Some airports have become huge shopping centers.

[19] See OECD, *Revenue Statistics* (1999).

[20] Governor Gilmore of the State of Virginia, who heads the U.S. Advisory Commission on Electronic Commerce, has been arguing that such commerce should be tax free.

[21] A recent article in the *New York Times*, January 10, 2000, p.1, entitled, "Online Sales Spur Illegal Importing of Medicine to U.S." gives a sense of the problem. The article cites the commissioner of the Customs Service that: "The Internet has given us a lot more work. We have been deluged with prescription drugs coming in from overseas. It is a major challenge to deal with this large increase in volume."

The second is the increasingly important change from the production and sale of physical to digital products. Many products which have been traditionally sold in shops, and in a format that gave them some physical content, will lose their physical characteristics and as a consequence the territoriality of the sales outlets will be more difficult to determine. Music, writing, photos, engineering plans, movies, medical advice, educational services, and so on can now be downloaded directly over the Net. Furthermore, the downloading can be done from almost anywhere in the world.

In the circumstances described above, the meaning of tax jurisdiction becomes vague. See Kobrin (1999). Who should pay the tax and who should collect the money? And how should this be done? In the brave new world of the future, the importance of physical products will continue to fall, while that of products made up of pure knowledge, and thus not having physical characteristics, which can be sold from anywhere in the planet will increase. Newspapers, books, records, and many other "products" will disappear as "products."[22] The full implications of these changes are still barely understood.

d. The growing importance of off-shores and tax havens as conduits for financial investments that to a large extent has been stimulated by the flow of digital information that allows money and knowledge to be moved easily and cheaply in real time. Estimates of these deposits are in the range of US$5 trillion. See UN (1998, p. 71). It is unlikely that many of those who earn incomes on these deposits report them to their national tax authorities.[23]

There is now growing interest on the part of the authorities of some large industrial countries to deal with this problem and the G-7 countries have been paying some attention to it. The United Nation has also been trying to attract attention to this problem. But the solutions are politically and technically very difficult. Thus, it remains to be seen whether this problem will continue to grow or some way will be found to contain it.

e. The growth of new financial instruments and agents for channeling savings, such as derivatives and hedge funds. Many hedge funds operate from off-shore centers and are not, or are little, regulated. Furthermore, the same problems mentioned with electronic commerce appear in even greater extent with electronic investments. There are huge problems of identification of individuals, of transactions, of incomes, and of jurisdictions where the

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[22] The phenomenal growth in the value of internet stocks in the past couple years is an indication of things to come.

[23] One reason is that some of this money represents laundered money. Additionally, it is very difficult, under existing rules, for national authorities to identify the owners of these accounts.

individuals live or where the incomes are generated.[24] In many cases, unless or until these incomes are repatriated and declared as incomes, their taxation will remain problematic.

f. The growing importance of trade that takes place within multinationals, among their different parts situated in different countries. This intra multinational trade now accounts for a large and growing share of total world trade. It creates enormous problems for the national tax authorities deriving from the use of "transfer prices" by the multinationals and from the likelihood that some of these enterprises manipulate these transfer prices to move profits to the jurisdictions where taxes are low. Under present tax arrangements this problem is likely to grow. The tax authorities of many countries are now worried about this trend but are often at a loss on what to do about it.

g. The growing inability of countries to tax, especially with high rates, financial capital and also incomes derived by individuals with highly tradable skills. High tax rates on financial capital or on highly mobile individuals provide strong incentives to the taxpayers to move the capital abroad to jurisdictions that tax it lightly or to take residence in low tax countries. The taxation of incomes from financial capital has become a major issue within the European Union and has been forcing countries either to lower marginal tax rates on incomes or to introduce dual income taxes.

h. The possibility that real money may begin to be substituted by electronic money in the normal transactions of individuals. In this case, the money accounts of individuals could be embedded in the chips of electronic cards which could be used to make payments and settle accounts. This trend would surely increase the difficulties of the tax authorities as well as those of the monetary authorities. See King (1996 and 1999).

These are examples of the brave new world we are entering and of the fiscal termites that I mentioned above. It is possible that the world community might be able to develop ways of dealing with some of them or of introducing new taxes. For example, off-shore centers and tax havens could be driven out of existence by strong, punitive actions on the part of the industrial countries. Countries might agree to unlimited exchange of information on taxpayers facilitated by computer technology.[25] Hedge funds might be subjected to closer scrutiny and strong regulations. Governments might learn to deal with transfer pricing or introduce new ways of taxing multinationals. And they might develop ways to monitor electronic commerce and electronic money or introduce new taxes such as "bit taxes," "Tobin taxes" or others. They may even create a World Tax Organization which would help in discussing the problems and in developing and coordinating solutions. See Tanzi (1999).

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[24] Often it is difficult to distinguish regular incomes from capital gains and many countries do not tax capital gains.

[25] However, legal restrictions and national interests are likely to prevent this from happening. See on this issue Tanzi (1995) and Tanzi and Zee (1999).

However, it is unlikely that all these actions will be taken or that they will succeed in killing all the fiscal termites. Thus, the conclusion must be that it would be prudent for many countries and especially for the welfare states to begin preparing themselves for what could prove to be significant falls in tax levels in future years.

VII. Concluding Remarks

The fall in revenue might come at the same time when governments experience the need for more spending in particular areas, either as a consequence of the aging problem or of globalization itself. Under current policies the ongoing demographic changes will create strong pressures on governments to spend more for health and for pensions. These effects will become particularly pronounced, in many countries, in about a decade from now when the baby boomers will begin to retire. But by that time the effects of globalization on the tax systems could become particularly strong.

Globalization may create pressures for increased spending for education, training, research and development, the environment, infrastructures, and for institutional changes partly to increase efficiency and partly to comply with international agreements. These expenditures are consistent with the traditional or basic role of the state in its allocation function. Thus, expenditure for social protection, which is a newcomer in the role of the state, could be squeezed between falling revenue and increasing needs for more traditional types of spending. In such a situation, the state will need to rethink its role in the economy.

A forthcoming book has shown that until 1960, in most industrial countries, public spending was less than 30 percent of GDP. See Tanzi and Schuknecht (2000). After 1960 there was a large increase in public spending in many countries to increase social welfare. However, it is not easy to prove that this large increase in spending actually contributed correspondingly to an increase in social welfare. See, ibid., and Tanzi and Schuknecht (1997).

Assume, for example, that between 1960 and the present time per capita income had increased at the same rate as it did;[26] but assume that public spending as a share of GDP had remained at the 1960 level. Does it necessarily follow that the welfare of society would have been necessarily lower? Individuals would have had more disposable income, because of lower taxes. Alternative ways of protection against various kinds of risks would have been developed by the market or by the individuals themselves. The governments could have focused their attention more directly towards those truly in need of social assistance and towards their more basic objectives rather than creating programs that involved the whole population. Perhaps this may happen over future years. The governments may progressively disengage themselves from many activities and may exploit alternative ways of achieving

[26] In fact, many would argue that the growth of per capita income would have been higher if the tax and spending increase had not occurred because lower taxes and lower social spending would have created less distortions and less disincentive effects.

these objectives with less direct financing. There are already many alternatives available from the experiences of various countries and a concentrated search for alternatives would undoubtedly generate other options to ensure essential or basic social protection will lower tax burdens.[27] But in such a world the power of the state to effectively and efficiently regulate relevant private activities would need to be enhanced. Without a stronger and more efficient regulatory activity on the part of the state and without much imagination on the part of policymakers the suggested change may not produce desirable results.

[27] The forthcoming book by Tanzi and Schuknecht (2000) includes several chapters that discuss some of these alternatives.

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