Fiscal Resilience - Termites of the State: The Elusive Search for Harmony Between State and Market [1]

By Vito Tanzi [2]

[1] Lecture prepared for presentation at the London School of Economics and Political Science on January 31, 2019, as part of the conference on Financial Resilience and Systemic Risk. The lecture is partly based on the author's book, The Termites of the State, (Cambridge University Press: 2018).
[2] The author received his PhD in economics from Harvard University, taught economics at several universities, was Director of the Fiscal Affairs Department at the IMF for 20 years, and served as Undersecretary for Economy and Finance in the Italian Government. He is the Honorary President of the International Institute of Public Finance.

I. Introduction

Much of modern economics deals with the short run. The existence of lags, between the time when policies are enacted and when their effects are felt, is largely ignored. Policies are assumed to have immediate effects, but lags can lead to unanticipated or even unwanted results. Economists should pay more attention to lags (Rohatinski, 2017).

The book on which this lecture is broadly based deals with the very long run. It covers three, somewhat distinct, though partly overlapping, periods. The first is the period from the mid 19th Century until the late 1920s. The second is the period from the Great Depression until around 1980. The third is the post -1980 period, until the arrival of the Great Recession. The decade that followed the Great Recession has taken some characteristics of its own, but it will receive less attention in this lecture (on that period, see Tanzi, 2015). In the above periods the government or, more broadly the state, played distinctly different roles. At times the roles played were close to what was needed by the market and expected by the majority of the populations; at other times, they were far.

The book deals with what may have been and remains the most important question in economics: the economic role that governments, or states, should play in democratic countries with market economies. How and why that role changed over time? How close did it come to what the market needed and the majority of the citizens expected? And why did the government role become increasingly more complex and easier to manipulate with the passing of time?

This lecture will focus on the main story, as told in The Termites of the State. It will ignore several important, specific issues discussed in that book, such as the economic role of constitutions; the growing role played by intellectual capital; the synergy that exists between governmental actions and the creation of private incomes, and others. The lecture focuses on the harmony that should exist between what the market requires from the government, to correct for its failures, and what the majority of the citizens expect from the government, to improve their welfare.

Views by economists and social scientists have oscillated over the years, between seeing the government as the enemy of the market, to seeing it as a needed substitute for it, and even as a solution for all social and economic problems. Ideally, in a market economy, the government should correct for market failures, and should be seen by the majority of citizens as a necessary complement to the market. It should not be seen as a substitute for it.

The market may, at times, require little and at other times more governmental intervention. There should be harmony between the corrections that the market needs and the expectations of the community from both the market and the government. This harmony exists only rarely, and generally it exists for brief periods. When the right balance is broken, the role of the government, or the operation of the market, or both, should change. Often the needed changes come late. Or, when they come, they may go too far and in turn, may create their own inertia and difficulties in future years. This happened several times in the past, when major disequilibria were created, between the actual, or positive, role of the state and the expected, normative, role. It also happened when the market was expected to perform miracles, thus excessively reducing the government role and creating difficulties.

II. The Period Before the Great Depression

For century the economic role of the state has attracted the attention of philosophers and economists. In the 19th Century there were two main and conflicting schools of thought on this issue: *laissez faire* and *socialism. Laissez-faire* has generally been attributed, not entirely correctly, to Adam Smith, who wanted the government to play a different role from the one it had been playing in his time, a role that he called *mercantilism*.

Socialism had several branches and many advocates during the 19th Century, when it attracted a large following. The two most important branches were: *Catholic socialism* and *Marxist socialism*. Catholicism had always stressed the virtue of charity and of sharing, and the associated notion that private ownership of property conveys for its owners social obligations. This aspect had been stressed in the Rerum Novarum, the important, economically –focused, Encyclical Letter, issued by Pope Leone XIII, in 1891. Catholic socialism had stressed that a market economy could be consistent with the ownership of large private property, and with inequality in the ownership of wealth, as long as the sharing obligation was followed. See, Ropke, 2006. Catholicism had also promoted monastic life, made possible by donations from rich people. Monastic life promoted a form of communism for those who chose it. In past centuries the number of monks has been high.

Marxist socialism was connected with the writings of Karl Marx and his associates. It had no role for the market, nor for private property. See Marx' Capital and, before Marx, Proudhon's 1840 book. Marxist socialism called for the socialization of all the means of production, and for the centralization of economic decisions focused on producing *basic* or *necessary* goods. Therefore, it would eliminate both the market and private property, and would promote equality in the standards of living. For whole communities it would promote a kind of generalized monastic life. Both kinds of socialism required changes in the role of the state, because of the great inequality that prevailed in the standards of living. But Marxist socialism required far more radical changes.

The Marxist view had its first, real–life, experiment in Russia, after the Bolshevik Revolution, in 1917. Later, it was tried in several, other countries, including the Soviet Republics and China, during Mao's Cultural Revolution. In some periods and in other countries, socialist views became popular. For example, at the beginning of the 20th Century, in Germany "The [Marxist socialist] party had practically won the cities…"(Ashley, 1904, p. 67). It also had strong following in other European countries, such as Italy and France. In Italy, Mussolini had been a socialist and the socialist party had published an important newspaper and remained important during much of the 20th Century.

The results from concrete socialist experiments are now well-known. As socialist economies became more developed and more complex, Marxism proved to be an unrealistic option, in its pure form. The original idealism, among those who had endorsed it, was progressively replaced by doubts, skepticism, corruption, and inefficiency. A new class, with implicit privileges, emerged, in the countries that had chosen the socialist way (Kornai, 1992). That idealism had called for the elimination of individualism and personal incentives that are characteristics that provide dynamism to capitalistic systems. Recent versions of it, that have given an important role to the market and to personal incentives, while leaving a significant economic role to the state in economic decisions, as in China, Vietnam and some other countries, have been more successful. However, de facto, these countries have abandoned the objective of equality and giving a major role to the market. Today, China hosts many of the world's billionaires.

Laissez faire requires a bit more attention because of its greater relevance for our time, that has seen some return to "market fundamentalism", and because there has been some misunderstanding about the role that it had played in the 19th Century. Laissez faire was never a completely free choice for the 19th Century's governments. And it was never practiced in its pure version.

The term **laissez faire** originated in France, when, Colbert, the powerful finance minister of the King of France, in a meeting with French merchants, asked them what the government could do to help them in their economic activities. One of them, Legendre, replied that the best help that the government could provide to them was, simply, to stay out of their way, and "**nous laissez faire"**: let us do our business without interfering. Clearly, the French merchants had seen the government as an obstacle, and not as a useful partner. At that time, **mercantilism** had been a common government practice, not just in France. Mercantilism was an extreme version of what some now call "*crony capitalism*". Governments intervened in many economic activities, by assigning monopoly power to some privileged individuals, or by providing other competitive advantages to others. *Laissez faire* had, thus, nothing to do with the level of taxes or public spending, but much to do with the arbitrary use of regulatory power by governments.

It is important to stress that, until the later part of the 19th Century, governments would not have been able to play a *modern* economic role, one requiring higher taxes and public spending, if they had wanted to. The reason was that they could not have had the financial resources required by it. They could not have been able to raise high tax revenue to hire the competent and well -educated bureaucrats needed to supervise and monitor modern and more costly economic policies. See Tanzi, 2018a and 2018b. Vilfredo Pareto recognized this fact when he wrote that : "governments try to get from their taxpayers all that they can; they are never stopped by lack of needs to be satisfied; the only obstacle is the resistance of taxpayers" in Pareto , 1916, vol II, p. 646 (my translation). To borrow was considered bad policy (Adam Smith, 1776, and Tanzi, 2016, and 2019). Because of the above reasons, laissez faire became an alternative to mercantilism and was preferred by economists. However, as the quotation from Pareto indicates, it was not, necessarily, the ideology that governments would have freely chosen, if they had faced different financial and political realities.

Until the beginning of the 20th Century, the tax level of the now- advanced countries had remained generally low, under 12-13 percent of GDP. That level was barely sufficient to cover essential governments' needs (a) to sustain the high standard of living of sovereigns, (b) to pay expenses for defense, (and, occasionally, to fight wars), (c) to pay for administration, justice, and essential infrastructure, and (d) to pay for other public goods (for data, see Paul Leroy –Beaulieu,1888, and Tanzi and Schuknecht, 2000). Why were the tax levels so low? It was not necessarily because of explicit policy choices. The tax levels were low for objective reasons, and laissez faire was not one of them, even though, classical economists clearly preferred low taxes.

The reasons for the low tax levels were several:

First, at that time, few citizens had the right to vote. Those who did vote were often males and property owners, individuals capable of paying poll taxes. These politically influential taxpayers and voters would not have supported policies that would require them to pay higher taxes. The widening of voting rights, especially during the first half of the 20th Century, and the extension of the right to vote to women, increased the popular support for higher tax levels.

Second, what I have called the "*ecology of taxation*" at that time would have made it difficult for governments to collect higher taxes, even if they had wanted to (Tanzi, 2018b). That ecology had much to do with the structure of the economies and with their prevailing informality. In the later part of the 19th Century, and especially in the first half of the 20th Century, the Industrial Revolution created large enterprises that concentrated the generation of much income and sales in few of them. This changed the ecology in which taxes were collected, and created the conditions that made it easier for governments to raise higher revenue, especially from income and sales taxes, the two tax bases that would provide a large share of most of the countries' tax revenue in modern times. Before the industrial revolution it would not have been possible for countries to collect much revenue from these taxes.

Third, higher tax revenue and better educational standards made it possible in the 20th Century for governments to hire better-trained bureaucrats, employees who had some of the Max Weber's ideal traits. These bureaucrats were better able to monitor complex modern policies**.** In the early part of the 20th Century, higher tax revenue and better trained and paid bureaucrats made it possible, for governments, to satisfy new, emerging, collective needs, and to reduce the wide gap that had been developing between, on one hand, the *desired* and *needed,* and, on the other side, the *actual* role of the state. The *need* for harmony between the two is evident from some Italian literature of the time. See Flora, 1909.

Industrialization, new technologies, and the growing urbanization were creating new needs for governmental intervention, needs that had not existed, or had been less felt, in the past. These new needs were increasingly recognized (Flora, pp. 3-4). Industrialized, urbanized, and democratic societies demand and need more public intervention (both higher public spending and more regulations) than do more primitive, informal, and rural societies.

The second half of the 19th Century had seen the introduction of many reforms leading some historians—for example, Woodward, 1938 1961—to call that period *the age of reform*. However, the reforms had been mainly related to demands **by** industrial workers **against** the owners of the private enterprises, **not against governments**. Most of the 19th Century's reforms had been directed at changing the existing relationships between workers and their private employers. The reforms had aimed at: (a) improving working conditions; (b) raising wages; (c) reducing working hours; (d) demanding some vacation time; (e) raising the age when children could work; (f) creating the rights of workers to organize and to strike; and (g) reducing accidents in the places of work**.** There had been the beginning of some shift of power from employers to workers. In addition to the above reforms, there had been pressures on governments to broaden the right to vote and to provide better schools. Most of the 19th Century's reforms had not been directed towards creating economic claims, or entitlements, *against the state*, as they would be in the 20th century, but at creating claims *against private employers*.

Laissez faire never fully existed in practice. Or, better, laissez faire had never been a genuine, free choice for governments. Classical economists, who at that time had little trust in governments, had advocated laissez faire as a lesser evil to the realistic alternative of mercantilism, and of other bad government interference. The attitude of economists, at that time, had led some observers (as for example, August Strindberg, a Swedish dramatist) to argue that "economics [had become] the science by which the economic elite remained the economic elite". Obviously, Strindberg did not have much faith in "trickle down".

The most important Italian economist around the middle of the19th Century, Francesco Ferrara, who was a true believer in the evil of state intervention, in 1853, would write that the use of import duties, by the US government, was a sin "as great as slavery". The USA committed this "sin" for much of the laissez faire period, and so did other countries. Countries used import duties as protective devises, as development tools, or simply to raise needed public revenue. Furthermore, governments often intervened with regulations and with other policies, to assist specific industries (cotton, coca cola, steel, petroleum, etc.) in various ways. Therefore, they were not immune to lobbying by private interests. Laissez faire was often used by some governments as an excuse for not intervening. By the early part of the 20th Century the gap between the role that governments were playing and the needed and increasingly -desired role had become very wide. This gap was leading to pressures for more governmental intervention.

By the turn of the 19th Century, the industrial revolution had advanced enough to radically transform the social and economic environment that had existed in the past. The change had made the need for new policies, and for a larger government role, increasingly felt. However, because of strong resistance from the elites, or the ruling classes, significant reforms would wait and would come mainly in the 1930s, pushed by the Great Depression, and after World War Two. The policy changes would, in time, reduce the wide gap that had existed between *desired* and *needed role of the state,* and the *actual*, *positive* role. The changes would, first, affect the market through regulations, and, then, increasingly, the whole society through higher taxes and public spending.

Around the end of the 19th Century there had been several important developments that would facilitate the later changes. They were:
the reforms introduced in Germany by Bismarck, that had provided, for the first time, minimum pensions for workers; the writings by Adolph Wagner, an influential German economist, who had argued that the economic role of the state was bound to grow, and that governments should play a role in redistributing income; the previously cited, Encyclical Letter of Pope Leone XIII in 1891, that had stressed the social obligations of the rich; and growing concerns about the status of the workers and the very uneven income and wealth distributions that existed at that time.

III. A Brief Digression on the Italian "Scienza delle Finanze"

Perhaps, because of the influence of Catholic Socialism in Italy and, after the Unification of Italy, in 1861, because of a government that many Italians did not see as *benevolent* and *representative* of all Italians the distribution of wealth and the economic role of the government attracted a lot of attention on the part of major Italian economists, social scientists, and statisticians (Tanzi, 2018d). They created a "Scienza delle Finanze", that was a distinct "School" different from the "schools" that prevailed in other countries. The "Italian School" generated a rich literature that, through James Buchanan, would come to influence the "Public Choice School" of recent decades (Buchanan. p.19 in Buchanan and Musgrave, 1999).

The main innovation of the Italian school was the rejection of the view that actual governments are generally benevolent and are interested in promoting the "public interest", however that concept is defined. The Italian School introduced various categories, or "ideal" types, of government --, *individualistic*, *monopolistic* and *paternalistic*, that may prevail in different places and times, recognizing that they were "ideal" categories that might not exist precisely in reality. See especially, Puviani, 1903 and Fasiani, [1941] 1950. The individualistic type was the one closest to the Anglo-Saxon conception. It made the public interest depend on individual preferences, as expressed through the ballot box. The monopolistic type was the most distant from that conception. In it, ruling classes, or plutocracies, come to control the government's apparatus and, using *fiscal illusions*, *fake and misleading facts* and other tricks promote policies that benefit the ruling class, or the elites. For a brief summary of this literature (Tanzi, 2000, chapter 1).

The monopolistic conception would be supported by some non -Italians. For example the German sociologist and political scientist Franz Oppenheimer (1864-1943) believed that the state is always born in the conquest of one group by another and the state has a lot to do with the distribution of wealth in a country. See his book [1922] 2007. In his Corso di Economia Politica (1896) Vilfredo Pareto allocated a lot of space to the distribution of income and wealth, and so did Achille Loria, a political scientist, in various editions of a book, first published in 1886, and republished in later editions in French and German.

In 1896, Gaetano Mosca, an influential social scientist, published his *Elementi di Scienza politica* in which he reported his historically- based, research findings about the role of minorities, as **leading classes** or **elites** in influencing economic outcomes in various countries. Mosca's views were shared by Pareto, and by others. These writings contributed to particular views on the political power of minorities. See Ferrarotti, 1973 .Four centuries earlier, similar but less precise views had been held by Machiavelli, in Il Principe. Mosca's insight contributed to promote a view, shared by many, that had important implications for countries that at that time were extending the right to vote. One implication was that it would be difficult to organize the large number of those who had acquired the right to vote, to contrast the power of already established elites. Thus, general suffrage was not assumed to easily reduce the power of plutocracies. To some extent, the views of Mosca, Pareto, Puviani and others with similar views were a warning about the necessarily good outcomes, in countries with democratic institutions and market economies, that many expected from the universal suffrage.

The above, simple but powerful, observations about the power of plutocracies can have major, political and economic implications. They can explain why it took several decades, and major disasters (wars, depressions, revolutions) to change significantly the role of the state and the distribution of wealth, even after most individuals had acquired the right to vote and when the economies had changed significantly to make it possible to raise the tax levels. They are also a warning that, in countries with very uneven income distributions (as, for example, the USA was until the 1920s, and is today), it is far easier for the richest 1, or 0.1 percent, than for the rest of the population to get organized behind policies that benefit them. And why It may take some dramatic events, such as revolutions, wars, or depressions, to bring real changes to the status quo.

Given the growing interest in income distribution, in 1912, the Italian statistician Corrado Gini would propose a statistic to measure how uneven the income distribution of a country is. That statistic would be widely used in later years. See also Benhabib and Bisin, 2018.

IV. From Laissez Faire to Welfare States

In addition to the developments mentioned above there were other events in the early years of the new century that had important implications. Some of these events were:

(**a**) The introduction in the USA of the income tax in 1913. This policy had been strongly resisted by the few rich individuals who would pay its very low rates.

(**b**) The continuing rise of the power of labor unions. That rise had started in the previous century, and was increasingly leading to major and violent strikes (See Loria, 1903; Woodward, 1961).

(**c**) The First World War, that would lead to large increases in taxes and in social demands (Peacock and Wiseman, 1961).

(d) The 1917 Bolshevik Revolution, in 1917, that would have a major impact on economists with socialist sympathies, of whom there were many (Lange and Taylor [1938] 1964).

(e) And the Great Depression after 1929.

The above events would all challenge the old world and the status quo, and would create pressures for a larger government role in the economy. Keynes had recognized the need for this change in a small book, published in 1926, appropriately called *The End of Laissez Faire,* and so had other less well- known economists (for example, Labriola, 1924). President Roosevelt would also recognize the need for change a few years later in the USA, by introducing, in the face of strong political opposition, the policies of the *New Deal,* which included both spending programs and greater regulations of market activities.

The Great Depression had accelerated the changes by raising questions and doubts about the claimed virtue of laissez faire, when the unemployment rate had reached 25 percent in the USA and 30 percent in Australia, and output had collapsed in many countries (Kindleberger, 1986). In the 1930s, Keynes would propose counter-cyclical fiscal policies to fight downturns, those policies would, in time, significantly contribute to the change in the future role of the government. In the decades that followed *redistribution* of income and *stabilization* of the economy would become new, integral parts of governments' operations. They would bring the role of government more in line with popular expectations, and, presumably, closer to market needs, beginning to close the gap that had existed, between desired and actual roles of governments.

By the end of World War Two: (a) many advanced countries were facing friendly *tax ecologies*; (b) most citizens (including women) had acquired the right to vote; (c) advanced countries had become highly urbanized**;** and (d) the attitudes of many, though by no means all, economists, had changed, because of the Great Depression, and were welcoming a larger and potentially beneficial role that governments could play, in promoting the welfare of most citizens, and in stabilizing the economies.

Proposals for changes in policies had been suggested in 1942, in the middle of the war by the Beveridge Report and, in the USA in 1944, by a "fire chat" by President Roosevelt. Eisenhower's presidential acceptance speech, in 1950, would make many references to a new role that the government could play, and Eisenhower was a republican representing conservative forces. All the above were indications of the ideological shift from laissez-faire that had taken place, and that was being increasingly recognized, even in conservative circles.

V. From the Keynesian Revolution to Market Fundamentalism

The age of the "Keynesian Revolution" and that of "welfare reforms", and the beginning of full- fledged welfare states had arrived. By this time the structures of the economies had changed in many countries, making it easier, for governments that wished to do so, to collect high tax revenue and to create bureaucratic apparatuses needed to implement and to monitor more complex government programs (Fogel, 2000).

If could be argued that, by the mid 1960s, the *normative* and the *positive* roles of the government had finally come closer, and the harmony that should exist between the government role and that of the market had significantly increased. At least this was a prevalent view at the time, although some conservative economists and politicians had a less favorable view of the changes. For example James Buchanan, the later Nobel Price Winner in economics, thought that, "under the weight of a Leviathan government", the USA was "plunging into anarchic chaos" and "democracy seemed unable to control its own excesses…" At the time this was clearly a minority view (Buchanan and Musgrave, 1999, p.22; for a more balanced but still conservative view, see Stein, 1969).

In the decades between the 1940s and the 1970s, the levels of taxes and of public spending would keep growing in most advanced countries, in some more than in others. The share of taxes into GDP rose from an average of around 13 percent, at the beginning of the 20th Century, and about 18 percent in 1920, to reach 30, or, in several countries, to exceed 40 percent of GDP in recent decades (Tanzi and Schuknecht, 2000). The use of regulations — not just to control the profits of monopolies, as they had done in the past, but to reduce new forms of negative externalities created by the actions of individuals and enterprises, and to control potential abuses — increased correspondingly, and so did in those years the power and the role of labor unions (Tanzi, 2018a).

The new urbanized setting in which many people lived, after World War Two, and the growth of large cities, in countries with deepening industrial activities, made more evident than previously that some negative externalities (pollution, traffic congestion and accidents, non -hygienic behavior, garbage disposal, excessive noises, smells, and others) needed to be controlled, and that only the government could do it.

The Great Depression had left deep scars in the social fabric of several countries, caused by the losses of incomes experienced by many workers and their families, at a time when there had been no formal safety nets and the earlier community or family- based safety nets had largely disappeared. This experience had increased popular support for government-based social programs (and for progressive taxes to pay for them). The "personal income tax", with its progressive features, had come to be considered an "ideal tax" in some surveys taken at that time. It had become a major tool of social engineering in many countries.

The new social programs, introduced in those years, financed by progressive tax systems, led to significant improvement in the income distributions until the 1980s. Policies were also introduced that protected employment and "workers' rights". With the passing of time, these new programs and rules started to create some rigidities and inefficiencies in the markets. These would intensify in the 1970s and would begin to attract increasingly critical attention. Once again, they would begin to create some disharmony between the needed and the actual role of the state. The slowdown of economic activities and the growing inflation in the 1970s would contribute to the view of the existence of this new disharmony.

In those years there had been a kind of bifurcation of the road taken by different governments of advanced countries. Some had chosen to raise the tax levels enough to finance some important, *universal* social programs made accessible, free or at highly subsidized rates, to all citizens, regardless of income levels. These programs reduced some financial risks for all the citizens of these countries. Several European countries (especially the Scandinavian countries) chose this "universal" route. Other countries, especially the USA and several other Anglo-Saxon countries, opted for a "*means-tested"* route, a route that allowed access to government programs for only citizens who met certain income or other criteria. Some governments (such as France, Italy, Belgium and some others, chose both routes).

The universal programs tended to be administratively and politically simpler, but they required more spending and higher tax levels. The means- tested programs were less expensive, but were administratively more complex. They required specific political decisions and more administrative resources to determine and control accessibility to the programs.

The countries that relied mostly on universal programs generally kept their tax systems less complex and more broad-based. For them the main objective of taxation remained the generation of revenue, respecting some broad criterion of vertical equity. The countries that relied mostly on the means-tested programs chose more complex tax system, to achieve, through taxes, and not through public spending, particular social or economic objectives. These countries made less use of value added taxes, and relied more on complex income taxes, and made use of "tax expenditures", "tax incentives", "special deductions", and other tax features, all aimed at achieving various social objectives through the tax systems, rather than through public spending. This inevitably led to far greater tax complexity. See Tanzi, 2018c.

Tax complexity tends to grow with time. In the USA, for example, the tax code and the related regulations now require tens of thousand of pages, compared with only about 500 pages until World War Two. "Compliance costs" and taxpayers' complaints, about the complexity of taxes, have risen significantly over the years. US taxpayers feel burdened by taxes, even though the US tax level has not changed much over the past half century and, for high-income taxpayers, it has fallen significantly (Tanzi, 2018b and Reid, 2017). In other Anglo Saxon countries, the tax level also increased less than in several continental European countries, but the complaints about high taxes intensified in these countries, because of the increased complexity (Tanzi, 2017).

Access to *means-tested* programs tends to grow with time, because of political pressures, bureaucratic maneuvers to make the programs more accessible, and increasing abuses and corruption. Means -tested programs create "poverty traps" because some individuals lose their public subsidies if they become employed, and poverty traps create dependency on the public programs, reducing efficiency. Universal programs do not, or do much less. By the 1970s taxes had generally become heavier, more progressive, and generally more complex in many countries, creating possible disincentive effects for working taxpayers, and some market inefficiency. Also the labor market had become over regulated and, perhaps, workers had become overprotected. This led to growing concerns by an increasing number of economists to the high and progressive tax rates, to the social programs that had required the high taxes, and to the increased regulations that had become more invasive. These reactions were especially strong in the Anglo Saxon countries, and they were intensified by the poor performances of many economies in the decade of the 1970s.

By the second half of the 1970s, the potential disincentive effects of high taxes and welfare programs, together with growing concerns about government inefficiency, and about reported abuses of means-tested programs, and concerns about the role that public sector unions were playing in particular areas (public schools and public enterprises), were being highly publicized and were influencing public opinion. This would lead to the election of very conservative policymakers in several countries.

Clearly the equilibrium that had existed in earlier years between the role of the market and that of the government had been broken. To maintain that equilibrium some adjustment would be required. The next equilibrium would see less government and more market.

VI. Supply-side Revolution and Market Fundamentalism

In the decade of the 1970 some conservative economists (Friedman, Hayek, Becker, Buchanan, Lucas, Stigler, and others), started attracting more followers to their anti, or small -government, views. The *Chicago School*, the *Austrian School* and the *School of Public Choice and some Think Tanks* became influential players in the intellectual market. They created strong academic and political oppositions to high tax rates and to welfare programs. Their influence was particularly strong in the countries where the social programs were largely means-tested, where the taxes had high marginal rates, and where tax expenditures and incentives had created significant complexity in the tax systems. Some important political figures began to see the government as an enemy of the market and of the capitalistic system (Reagan, Thatcher, and others). The government had become a Leviathan to be controlled, while the market came to be seen as an efficient and much admired instrument. The contrast with what was happening in the "socialist" countries that had abolished the market contributed to these views.

Concepts such as the "Laffer Curve", "Ricardian Equivalence", "Rational Expectations", "Efficient Market" and others attracted large followings among academic economists, and among politicians. The political winds were clearly changing, from those that had blown in favor of the government, in earlier years. The new winds created skeptical attitudes toward the large, economic role that governments had assumed in many countries in the previous decades. The ground was ready for the pro- market, "supply-side revolution" of the 1980s.

The supply-side revolution played a role in the election of highly conservative policymakers in several countries (UK, USA, Canada, Australia, New Zealand and some others). "Market fundamentalism", a modern day laissez faire ideology, became popular. It could be seen as a return to the laissez faire, but, unlike its 19th century counterpart, it was now a free choice. In the 1980s and 1990s many observers came to believe that the market could solve many problems, if governments allowed it to. High tax rates and regulations came under attacks, and the government role was scaled down in several countries in the following two decades.

The economic results generated by the work of the freer market—in terms of income generation and income distribution, and in terms of the assignment of values to economic activities —acquired an almost ethical justification (Sandel, 2012. The scope of the market was expanded by economists such as Gary Becker and others. The market came to encroach on, or to replace, some values that, in the past, had been based on traditional, community norms. Many came to believe, that market outcomes were always right, and should not be challenged. This justified and gave legitimacy to very high incomes for some individuals, at a time when the marginal tax rates on those incomes were being sharply reduced, and the income distributions were becoming more uneven.

A period of privatization of many activities followed (in pensions, schools, jails, infrastructures, fighting wars, and even in the resolutions of some disputes between employees and enterprises). Important changes in the tax systems were made (such as dramatic reductions in marginal tax rates, changes in the "architecture" of the income tax, which gave preferential treatment to incomes from capital sources). See Tanzi, 2014. In important sectors (such as the financial market, the labor market and the environment) regulations were sharply reduced. Labor unions lost much of their powers, and the managers of private enterprises acquired much more power.

The supply-side revolution had been expected by its supporters to generate miracles in terms of economic efficiency and growth, without making the income distributions less equitable. "Trickle down" effects would assure that everyone benefited from the new policies. Unfortunately, growth did not pick up as significantly as expected, and the growth that occurred did not benefit a large share of the workers. The income distributions of many countries, and especially that of the USA, became much less equal. The income growth that occurred benefitted mainly a few. The expected "trickle down" did not raise the wages of average workers.

The supply-side revolution came at a time when both the operations of the market and the activities of governments (including in the social programs and in the writing of laws and regulations) were becoming increasingly complex. The growing complexity was creating more opportunities, for clever and less scrupulous individuals, and for lobbyists representing special interests, to exploit both the operations of the complex market and those of the complex government programs. Opportunities had been created to extract rents. Policy changes and complexity contributed to the growing income inequality and, in time, would create bubbles in the economies.

This new environment would lead to the financial crisis of 2007-2008 and to the Great Recession that followed. An increasing number of observers would start defining the work of the market and the operations of governments (and, as a consequence, the capitalistic system) as "crony" or "casino" capitalism (Sinn, 2010).

With the impact of new technological developments, and with globalized economic activities**,** the *free market had definitely changed, in important and not always desirable ways*. It had come to resemble less and less the cozy and efficient instrument described and idealized by Hayek and Von Mises, of the Austrian School, and by Friedman and Stigler, of the Chicago School. In many exchanges, it had come to be characterized by the existence of many of the "lemons" that George Akerlof had described in a seminal article in 1970. "Lemons" are market exchanges in which symmetry in the information, that should be available to both parties of an exchange, is missing. The existence of "lemons" has significantly increased over the years. As a consequence, *an increasing share of market exchanges can no longer be assumed to be welfare improving*.

Termites have entered in many of the operations of the market, and also in those of the government. The economic sectors in which asymmetry in information can easily exist have grown as shares of countries' GDPs. These sectors include: finance, that has become increasingly complex and global; insurance; private health; house and car repairs; provision of various services, including tourism and legal services; exchanges of goods across frontiers; and even in the writing of tax laws.

Many products and services have become too complex for their true value to be easily understood by most citizens. Many products (including the growing share of "fakes" in the market) are no longer bought from nearby known suppliers, as they were in the past, when economic activities and exchanges had been mostly local, and mostly among locals. Many of the products consumed in modern, globalized economies are now imported from far away places, and are bought from unknown producers. They may have been produced under hygienic and environmental conditions, or may contain defects that are unknown to the buyers.

The *asymmetries have reduced or nullified some of the benefits from market exchanges*. *Ex ante*, it has become more difficult for an individual to know with some confidence the real value of what he or she is getting from an exchange, or from a contract, as happened in many of the financial transactions that led to the "sub-prime crisis". Often, the terms of formal contacts are buried in fine prints, and the contracts are written in "legalese", a language that only few can read and understand.

The asymmetry in information has worked its way into many of the operations of the public sector, including the drafting of laws, the interpretations of regulations, and others. New laws have become thousands of pages long and, because of their length, they are approved by legislators and policymakers who, in many cases, have not even read them (Tanzi, 2011, Chapter 14). As a consequence, *termites* (including the work of *lobbies*) can more easily penetrate the writing of the laws and of the regulations, and/or change their interpretations, leading to abuses. It has become more difficult for a citizen what he/she is getting from a new legislation.

The existing laws have grown in numbers (in many countries to many thousands) and in complexity. This development has created an almost impenetrable legal jungle for most citizens, and one that can be easily exploited to their advantage, by clever individuals, and by representatives of special interest groups. The result has been a less transparent form of the mercantilism that had prevailed during Adam Smith's times. Privileged and/or clever individuals, now form of new ruling class, they have been the major beneficiaries of some of the governments' more recent activities.

VII. The Current Problem with Income Distributions

During the 1980s and 1990s *marginal* tax rates were dramatically reduced in several countries, especially those important for high- income individuals, while *average* tax levels did not change much. This happened at a time when the earnings of the very rich were rising rapidly. In an increasing number of cases, some of the high "earnings" had started to resemble "rents" (i.e. partly *unearned* or *undeserved* incomes) more than truly *earned* and *deserved* compensations. This development contributed to growing skepticism about the ethics of the market, and also about the democratic processes, a skepticism that, in recent years, has contributed to promoting populist movements in several countries and has led to the election of some policymakers who may not fully share the merits of democratic processes, or understand the potential efficiency of markets.

The decades after the 1970s experienced what could be defined as a *perfect storm* (the third part of Tanzi, 2018a)**.** It was a storm that, in several countries, and especially in the USA, led, or contributed, to income distributions that became as uneven as they had been in the 1920s. The share of total income received by those at the top 1 or even 0.1 percent of the income distributions increased dramatically, giving these individuals great market and, increasingly, greater political power. This happened while the incomes of most workers stagnated. It was hardly a development that many would have defined as utilitarian.

Perfect storms, generally, have several elements that combine, in unanticipated ways, to make the storms powerful. Some of these elements are mentioned below without elaboration. Some were the direct consequence of the market fundamentalism that had influenced the role of the state, in several countries, especially in the decades of the 1980s and 1990s.

The first element of the storm was the role played by the expanding and government- protected concept of *intellectual property*. Over the years, technological developments and public policies had created new possibilities, for some of those who could establish claims to intellectual property, to extract large profits from, unregulated, but government -protected, monopolies. In many cases, the same genuine effort, by an individual, that in the distant past would have earned that individual a modest income, led to very large earnings (Tanzi, 2018a, Chapters 30 and 31).

The change was in part due to government policies, policies that protected intellectual property rights and that assigned time-limited but extendable monopoly power, over some output, to the owners of those rights. This policy could be considered a modern day version of mercantilism. The change in earnings was magnified by past technological developments, such as the internet and others, that had been mostly financed by governments. As a consequence of these developments, it became possible for the owners of intellectual property to sell their output to a huge number of buyers, at times buyers from the whole world. This had been made possible by the government's past policies. Some of the world richest individuals today became rich in this way.

The second element of the storm was the novel view, promoted by some economists in the 1970s and 1980s, that *large* financial incentives can have a great impact on the performance and on the productivity of particular individuals, especially corporate managers. The larger are the incentives, the greater are assumed to be the effect of the bonuses on the productivity of those who receive them. No limit was assumed to exist in this relation, implying that the productivity of individuals can be stretched to infinity by financial incentives. This strange and novel view came to justify the asking for, and the giving of, huge bonuses, and the large compensations that many CEOs and other managers have received in recent decades.

Strangely, the new view was not assumed to apply to normal workers. For them financial incentives were assumed to be ineffective. Therefore, this thinking encouraged the managers of enterprises to squeeze the wages of their workers, while they increased their own share in the total net income of enterprises. This process was facilitated by the ongoing globalization, and by the weakening of labor unions, that had taken place and was still taking place. For average workers, financial incentives, such as higher wages, were not assumed to make them more productive.

The average compensation of managers rose, from the five times the average wages of workers, that the first Nobel Prize in Economics, Ian Tinbergen, had considered normal and desirable in the 1960s, and from the 20 times the level that some years later had been assumed desirable, by Peter Drucker, the famed management expert, to levels that, at times, reached or exceeded 500 times average wages. There was no longer any embarrassment, on the part of managers, to ask for and to obtain, from their, often docile, boards, compensations that, in some cases, reached hundred of times the level of the cash salary of the US president.

Because of complex and often non- transparent compensation contracts, some managers got these high compensations even when the performance of the enterprises that they managed had been far from admirable; or when they had driven some large banks into bankruptcy (Tanzi, 2014, and Stenfors, 2017). The view was that, because the free market is always right, the outcomes of the market must be justified, and they should not be questioned. Any compensation level should be considered right.

The third element of the storm was the changes in the tax systems that occurred in many countries in the 1980s and 1990s. In those years the highest marginal tax rates, the rates that are important for the highest income earners, were dramatically reduced. In the USA, in the 1980s, the highest tax rate was reduced from 70 to 28 percent, while taxes on capital income were also slashed. See Tanzi, 2014. The growing complexity in the tax systems, combined with the effects of globalization, created new opportunities, for high net worth individuals and for corporations, to evade or to avoid paying taxes. See Tanzi, 2018b. These changes had dramatic effects on the after tax income distribution.

Other factors, such as deregulation, especially in the financial market (Stenfors, 2017) the weakening of labor unions, some technological developments, and some others, also played significant roles, in changing the social and the economic landscape in recent decades. Clearly the closer harmony, that might have existed in the late 1980s and early 1990s, between the desired role of the state and that of the market, was again compromised by these developments. The ruling class had reestablished ifs supremacy.

VIII. Concluding Comments

The final question to be addressed is whether a market economy, in still democratic countries, can retain its legitimacy and the countries' citizens can retain their respect for the political system when the income distribution becomes so uneven, and when it creates a new class of privileged individuals who, increasingly, feel that they are different from the rest, tend to live in separate areas, and that they are entitled to their incomes and privileges, including that of being able to influence public policy with their money. In democratic countries individuals can promote their rights with both their political votes and with their financial power. As Gaetano Mosca, the 19^{th} Century Italian sociologist, stated, "Political power produces wealth and wealth produces political power" (reported in Ferrarotti, 1973, p. 59.) One, as the author of this paper, who lives in Washington DC, cannot fail to miss the fact that the fastest growing industry in this city is that of lobbying.

This was the situation that had existed in the years before the Great Depression. Because of it, in 1926, Lord Keynes had called for "new knowledge" to deal with it. New knowledge is clearly, needed again, today, to develop new, needed policies. This new knowledge would aim at promoting more harmony between the *desired* role of the state and the economic and the *results* that they deliver, *without revolutions or depressions.*

It should be stressed that what is called for is **not the elimination of the market, or a return to socialism,** because in spite of its current shortcomings, the market remains the fundamental and irreplaceable economic instrument for allocating resources. What is called for is to make the market operate in a way to promote the welfare of the whole or at least the majority of the population, and not that of only small parts of it. Many believe that, in many countries, the desired harmony between market and state no longer exists today. Without that harmony, the world risks moving in uncertain and not desirable directions, as it did in Russia in 1917, and in several other countries in 1929.

The *new harmony* would require, inter alia,: (a) governments that are less exposed to lobbies and pressure groups; (b) public policies that are less complex and more transparent, including those related to tax systems, to means-tested programs, and to the financial markets; (c) less inequality in opportunities for citizen and less inequality in results; and (d) governments with the capacity to regulate efficiently and equitably. Clearly this is a demanding task. It points to the difficulties that would be encountered in developing the needed "new knowledge", and in the use of that knowledge. But without that new knowledge, countries with well -functioning democratic processes and market economies risk becoming relics of the past.

References

Akerlof, George A., 1970, "The Market for "Lemons": Quality, Uncertainty and the Market Mechanism", Quarterly Journal of Economics 84 (3) (August) pp488-500.

Ashley, W. J. 1904, The Progress if the German Working Classes: In the last quarter of a century (London, New York and Bombey: Longmans , Green , and Co.)

Benhabib Jess and Alberto Bisin, 2018, "Skewed Wealth Distributions: Theory and Empirics", Journal of Econombridge, mass, ic Literature, December 2018 Vol LVI, Number 4, pp. 1261-1291.

Buchanan, James and Richard A. Musgrave, 1999, Public Finance and Public Choice: Two Contrasting Visions of the State (Cambridge, Mass.: MIT Press).

Ferrarotti, Franco, a cura di, 1973, La sociologia del potere (Bari: Universale Laterza).

-------------, a cura di, 1973, Pareto: Un'antologia (Milano:Oscar Mondadori).

Flora, Federico, 1909, Manuale della Scienza delle Finanze (Livorno: Raffaello Giusti, Editore).

Fogel, Robert William, 2000, The Fourth Great Awakening and the Future of Egalitarianism (Chicago: The University of Chacago Press).

Fasiani. Mauro, 1951, Principii di Scienza delle Finanze, Second Edition, Volume one and Volume Two (Torino: G. Giappichelli Editore).

Keynes, John Maynard, 1926, The End of Laissez Faire (London: Hogarth Press).

Kindleberger, Charles P. 1986, The World in Depression, 1929-39, (Berkeley, Los Angeles, London: University of California Press).[

Kornai, Janos, 1992, The Socialist System: The Political Economy of Communism (Princeton: Princeton University Press).

Labriola, Arturo, 1924, La dittatura della Borghesia e la decadenza della societa' capitalistica (Napoli: Alberto Morano Editore).

Lange, Oskar and Fred M. Taylor [1938] 1964 , On the Economic Theory of Socialism (New york" McGraw-Hill book Company).

Leroy-Beaulieu, Paul, 1888, Traité de la Science des Finances (Paris: Guillaumin).

Loria, Achille, 1903, Il Movimento Operaio : Origini, Forme, Sviluppo (Milano, Palermo, Napoli: Remo Sandron)

---------------, 1913, Le Basi Economiche della Costituzione Sociale (Milano, Torino, Roma: Fratelli Bocca Editori).

Machiavelli, Nicolo', 1995, Il Principe, (Torino: Einaudi).

Marx, Karl [1867-94] 1978, Capital (New York: Pinguin).

Mosca, Gaetano, [1896], 1938 Elementi di scienza politica (Rome: Fratelli Bocca).

Musgrave, Richard A. and Alan T. Peacock, , editors, 1958, Classics in the Theory of Public finance, International Economic association (London: Macmillan & Company).NEW YORK, LONDON: BLACK ROSE BOOKS).

Oppenheimer, Franz, [1922] 2007, The State (Monreal,New York, London: Black Rose Books),

Pareto, Vilfredo, 1953 [1896] Corso di economia politica, Volume I and Volume II (Torino: Edizioni Scientifiche Einaudi).

------------, [1916] 1964, Trattato di sociologia generale (Milano: Comunita').

Peacock A. and J. Wiseman , 1961, The Growth odf Public Expenditure in the UK (Princeton: Princeton University Press).

Proudhom, Pierre-Joseph, [1840] 2009, Qu'est-ce que la propriété? (Paris: Prisa Innova, S.L.).

Puviani,Amilcare,[1903] 1973 Teoria dell'illusione Finanziaria (Milano: Isedi).

Reid, T. R. , 2017, A Fine Mess: A global Quest for a Simpler, Fairer, and More Efficient Tax System (New York: Pinguin Press)

Rohatinski, Zeljko, 2017, Time and economics: The Concept of Functional Time (London: Palgrave macmillan).

Ropke, Wilhelm, 2006, Il Vangelo non e' socialista: Scritti su etica Cristiana e liberta' economica (1959-1965) (Catanzaro: Rubettino)

Sinn, Hans-Werner, 2010, Casino Capitalism: How the Financial Crisis Came About and What Needs to be Done Now (Oxford: Oxford University Press).

Sandel, Michael, J., 2012, What Money Can't Buy: The Moral Limits of Markets (New York: Farrar, Straus and Giroux).

Smith, Adam, [!776] 1999, The Wealth of Nations, Books I-III (Penguin books)

---------------[1776] 1999, The Wealth of Nations , Books IV-V).

Stenfors, Alexis, 2017, Barometer of Fear: An insider's Account of Rogue Trading and the Greatest Banking Scandal in History (London: Zed Books).

Stein, Herbert , 1969, The Fiscal Revolution in America (Chicago and London: The University of Chicago Press).

Stigler, George J. 1965, The Citizen and the State: Essays on Regulation (Chicago and London: The University of Chicago Press).

Tanzi, Vito, 2000, Policies, Institutions and the Dark Side of Economics (Cheltenham, UK: Edward Elgar).

-------------, 2011, Government Versus Markets: The Changing Economic Role of the State (Cambridge University Press).

----------, 2014, "The Challenges of Taxing the Big", Revista de Economia Mundial, 37, 2014, pp. 23-40.

-----------, 2015, "Fiscal and Monetary Policy During the Great Recession: A Critical Evaluation". Comparative Economic Studies , 2015, 57, pp. 243-275.

-----------, 2016, "Pleasant Dreams or Nightmares in the Public Debt Scenarios?" Paper presented at the Conference for the retirement of Hans-Werner Sinn.

----------, 2017, "Corruption, Complexity and Tax Evasion", In e Journal of Tax Research, Volume 15, Number 2, December 2017, pp. 144-160.

--------------, 2018a, Termite of the State: How Complexity Leads to Inequality (Cambridge University Press).

--------------, 2018b, The Ecology of Tax Systems (Cheltenham, UK, Northampton, MA, USA:Edward Elgar).

-------------, 2018c, "The Design of Welfare Systems", paper presented at the 2018 Congress of the International Institute of Public Finance, Tampere, Finland, August.

-------------, 2019, "The Irresistible Attraction of Public Debt". Forthcoming in a book in honor of James Buchanan, edited by Richard Wagner.

---------------and Ludger Schuknecht, 2000, Public Spending in the 20th Century: A Global Perspective (Cambridge University Press).

Woodword, Sir Llewellyn F.B. A.,[1938] 1962, The Age of Reform 1815-1870, Second Edition (Oxford:Clarendon Press).