Will Technology and Global Capital Markets Change the Scope of Government?

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Many libertarians—or, as people from the other side of the Atlantic would call them, "classical liberals"—hope that the combination of the globalization of finance with the onset of new technologies will transform modern government back into a night-watchman state. What to liberals is a hope, to others is a source of great anxiety. But both the hope and the fear are exaggerated. The changes now under way will have an impact on government. Of that there can be no doubt. But the belief that a drastic reduction in the scope of government is preordained is almost certainly wrong.

One reason for this conclusion is that globalization is chosen, not imposed, like some *deus ex machina*. After World War II, the world witnessed what amounted to a competition over economic freedom. By the 1980s, it had become obvious that the market economies had outperformed the controlled economies. That realization led to a worldwide move toward market liberalism, the most dramatic example being the collapse of the Soviet empire. A particularly important component of this worldwide transformation was liberalization of exchange controls. Development of integrated global capital markets was then the result. While technology played a part in that development, it could not have happened without policy choices. Thus, globalization is best understood as a *consequence* of decisions to limit government intervention.

Some people have a different, quasi-Marxist, view. They believe that the new technological basis of the economy will compel a radical transformation in the state superstructure, because the state is ineluctably losing its capacity to tax and regulate. People who hold this

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view think that the ability of governments to control resources is collapsing, either because those resources are much more mobile than hitherto, or because they are more invisible to the authorities, or for both of these reasons together.

The proposition that the lessons of experience have persuaded most countries to move in the direction of liberalization and that globalization is the result is incontrovertible. That technology preordains a radical diminution of the power of states is quite another matter. To explore the constraints imposed upon—or chosen by—governments, attention will be paid below to three aspects of government activity: taxation, income redistribution, and macroeconomic management.

Taxation

It can be stated quite confidently that, on any measure, the extent of international economic integration has been increasing and the costs of transport and communication have been falling, over the past half century. Yet there is no evidence that this has reduced the ability of states to raise taxes. What is striking, in fact, is how high and variable tax ratios continue to be. In 1999, the ratio of tax and nontax receipts to gross domestic product among member states of the Organization for Economic Cooperation and Development (OECD) varied from 31 percent in Japan and the United States, to 50 percent in France, 57 percent in Denmark, and 59 percent in Sweden (Table 1). The latter ratio is slightly down from its peak of 61 percent in 1989, but in some high-income countries tax ratios were higher in 1999 than ever before: Germany was one example; France was another. For the European Union as a whole, the tax ratio was also higher than ever before and, intriguingly, the same was true for the United States, though at a far lower level.

For this reason, Clive Crook of *The Economist* has argued that "big government, far from being dead, has flourished mightily" (Crook 1997). Over the last century, government spending and revenue have both grown far more quickly than GDP. An important book by Vito Tanzi, of the International Monetary Fund, and Ludger Schuknecht, of the European Central Bank, underlines this point. In *Public Spending in the 20th Century,* Tanzi and Schuknecht (2000) show that the average share of government spending in the GDP in the member states of the OECD jumped from an eighth to almost a half. In real terms, spending increased some 70-fold.

True, as Tanzi (2000) also notes, "in most countries in recent years, the tax level has stopped growing." But that is at least as much due to

TABLE 1
Government Revenue as a Percentage of GDP

	1983	1990	1999
United States	28.3	29.3	31.0
Japan	29.6	34.2	30.5
Germany	45.3	41.8	46.0
France	47.7	47.7	50.2
Italy	38.2	42.1	46.3
United Kingdom	n.a.	40.3	40.3
Canada	38.9	42.1	42.8
European Union	43.0	43.0	45.6
Euro Area	42.6	42.6	46.0
Denmark	n.a.	55.0	57.4
Sweden	56.8	60.5	58.7
Total OECD	33.6	35.5	36.9

Source: OECD (2000).

electoral resistance as to insuperable difficulty in collecting taxes. Tanzi believes this is about to change. Indeed, he provides a list of "fiscal termites" gnawing at the foundations of fiscal regimes. These insects include more cross-border shopping, increased mobility of skilled labor, growth of electronic commerce, the expansion of tax havens, the development of new financial instruments and intermediaries, growing trade within multinational companies, and the possible replacement of bank accounts with electronic money embedded in smart cards.

The list is impressive. That governments take it seriously is demonstrated by the attention being devoted, within the OECD and the European Union, to "harmful tax competition," exchange of information, and the implications of electronic commerce (OECD 1998a, 1998b). In other words, governments are, like any other industry, forming a cartel to halt what they see as "ruinous competition."

Yet, the threat governments now face must not be exaggerated. To appreciate this, it is helpful to analyze fiscal developments under three heads: factor mobility, collection of information on income and spending, and the impact of the Internet on both mobility and collection of information.

The fiscal implications of mobile labor, capital, and spending are well-known: this is the world of local government, analyzed by Charles Tiebout (1956) in a classic article. Local governments can impose higher taxes than their neighbors, provided they contain location-specific resources or offer location-specific amenities that resi-

dents desire and can consume only if both present and assessable. Countries could, at the limit, become just like such local governments, though legal, linguistic, and cultural barriers are likely to keep cross-border mobility far smaller than within countries.

It is much easier to tax some things than others: income of mobile capital is hardest to tax; land and income of land and immobile labor are easiest; with corporate earnings in between. Corporate income can certainly be taxed to the extent that it derives from location-specific resources, be they natural or human. Spending can also be taxed more heavily in one jurisdiction than another, but not if transport costs are very low, either because distances are short or items are valuable in relation to costs. Similarly, it is difficult to tax personal incomes if people can live in low-tax jurisdictions while enjoying the amenities of high-tax ones. For this reason, the geographic size of a jurisdiction can be an important determinant of its ability to raise taxes.

The conclusion then is that enhanced mobility combined with freedom of jurisdictions to set their own tax rates will constrain the ability of some jurisdictions to levy much higher taxes than others, but will certainly not eliminate it, above all to the extent that taxable resources or activities remain relatively immobile, as will be true for much labor, or the jurisdiction provides valuable location-specific amenities.

Enhanced mobility is one result of globalization. Greater difficulty in obtaining information is another. As the impact of mobility works through, jurisdictions will find it increasingly difficult to know what their residents own and spend abroad. Yet, again, it is important not to exaggerate the difficulties. People are inherently physical. Most of what they consume is also physical. It is, in consequence, difficult to disguise most of their consumption or, in consequence, the income that finances it.

Finally, consider the impact of the Internet. A paper by Stephane Buydens (2000) of the OECD argues, plausibly, that the impact of the Internet will be felt in four main areas: taxes on spending, tax treaties, internal pricing of multinational companies, and tax administration. Pure Internet transactions—downloading of films or music—will be hard to tax. But where the Internet is used to buy goods, this should be less of a problem. It will then be necessary for the fiscal authorities to obtain cooperation of suppliers. To the extent that these are large public companies, that may not be as hard as is often supposed. Such companies have to cooperate with the authorities of the jurisdictions in which they raise capital and employ people.

The Internet also creates a problem in identifying the location of a server. If one cannot do so, how is tax to be levied and tax treaties

TABLE 2
CORPORATE INCOME TAX AS A PERCENTAGE OF GDP AND FISCAL REVENUE, 1997

	Corporate Tax as Share of	
	GDP	Fiscal Revenue
United States	28.3	9.4
Japan	4.3	15.0
Germany	1.5	4.0
France	2.8	5.8
Italy	4.2	9.5
United Kingdom	4.3	4.3
Canada	3.8	10.3
European Union	3.5	8.5
Denmark	2.8	5.2
Ireland	3.3	10.0
Sweden	3.2	6.1
Total OECD	3.3	8.8

SOURCE: OECD (1999).

applied? Similar problems arise with internal pricing of multinational companies. It will become still harder to locate their activities than before.

What then are the overall conclusions for the future of taxation? First, the combination of economic liberalization with advances in technology poses significant challenges. Taxes on spending may have to be partially recast. Taxation of corporate profits may have to be radically redesigned or abandoned.

Second, the ability of governments to impose taxes that bear no relation to the benefits provided to the payers will be more constrained than hitherto. But people will still be willing to pay for desired, location-specific amenities.

Third, the implications of these changes can easily be exaggerated. Taxation of corporate income is, for example, rarely more than 4 percent of GDP or 10 percent of fiscal revenue (Table 2). Taxes on labor income and spending are the universal pillars of the fiscal system. Yet even lofty Scandinavian taxes are not forcing skilled people to leave in droves. It is worth noting that Scandinavia is also the most new-economy-intensive part of the European economy.

Finally, governments will use exchange of information and other forms of cooperation to sustain revenue and may even consider international agreements on minimum taxes. They will certainly force

the publicly quoted companies that continue to dominate transactions in the world economy, both online and offline, to cooperate with fiscal authorities. But competition among governments will not be eliminated, because it is not in the interest of powerful governments, not least that of the United States, to let that happen. The countries that provide a relatively low-tax, low-spending environment will want to maintain it.

The bottom line is that the opening of economies and the new technologies are reinforcing constraints that have already developed within domestic politics. Governments of countries are becoming a little more like local governments. The result will not necessarily be minimal government. It is more likely to be better, less predatory and exploitative government. Like every other institution, governments will be forced to provide value for money to those who pay for their services.

Income Redistribution

It follows that the use of the fiscal system for income redistribution will also be more constrained. It is possible for governments to continue to redistribute income to the extent that those responsible for the more highly taxed activities or factors of production cannot—or do not wish—to evade or avoid that taxation. They may, in fact, be quite willing to pay the taxes, because they regard income redistribution as a location-specific benefit. That may be because they identify with the beneficiaries, fear that they could themselves become beneficiaries, or treasure the greater security that comes from living among people who are not in a desperate plight. Alternatively, they may merely be unable to evade or avoid those taxes without relocating physically outside the jurisdiction, which they are loath—or find difficult—to do. Indeed, it is worth noting that the international mobility of people is less now than it was a century ago. For all these reasons, it will be possible to sustain a high measure of redistributive taxation and, in particular, of social insurance.

Indeed, Dani Rodrik (1997) of Harvard University has even argued that small open economies have higher ratios of public spending in GDP, to insure citizens against the risks inherent in exposure to the international economy. In big countries, by contrast, the diversification of the economy itself tends to provide a form of implicit insurance. What is certain, in any case, is that income redistribution is possible, provided the case for it is made and accepted by the taxpayers.

Macroeconomic Policy

Last but not least, it is argued that globalization limits the ability of governments to run fiscal deficits and pursue inflationary monetary policy. The fundamental point, however, is that macroeconomic policy is always vulnerable to the reaction of the private sector, whether or not the capital market is internationally integrated. If a government pursues a consistently inflationary policy, for example, long-term nominal rates of interest will rise, partly to compensate for inflation and partly to insure the owner of the bonds against inflation risk. Similarly, if a government relies on the printing press to finance activity, there will be flight from money into goods, services, and assets. This will, in turn, generate inflation.

In the purely domestic context, these reactions may be slow. A government may be able to pursue an inflationary policy over a long period, with attractive consequences for real economic activity, before the chickens come home to roost. What difference then does it make for the country to be open to international capital flows? The most important change is that the reaction of a government's creditors is likely to be quicker and more brutal because they have more alternatives. This will often show itself in a collapsing exchange rate, as was shown in East Asia in 1997 and 1998.

It is important to note, however, that the decision to borrow abroad is itself a voluntary one. The constraint is self-chosen, usually for the reason that it increases the available pool of funds. The challenge for a government is to minimize the risks consequent upon that choice.

Conclusion

The implication then is that a country that chooses international economic integration implicitly accepts constraints on its action. Nevertheless, the hypothesis that those constraints entail the withering away of the state's capacity to tax, regulate, or intervene is wrong. It would be more accurate to say that the impact of international economic integration is to accelerate the private sector's response to policy, by increasing the range of alternative options available to those affected.

The arrival of improved technology for international communications reinforces these tendencies, but does not mean a preordained end to the state's ability to tax and spend. It would be more sensible to think of technology as turbo-charging the impact of openness. But so long as the movement of people is limited and their spending is visible, states can continue to raise taxes and redistribute incomes.

The bottom line then is that global financial markets and new technologies will not force governments back to a late 18th century role. Nevertheless, constraints on the state will become somewhat tighter. Governments will find it far more difficult to pursue an inflationary policy. Equally, they will be unable to raise penal taxes. Instead, they will be forced to relate the taxes they raise to the benefits they provide. No doubt, governments will try to limit the implications of the competition they are in through cooperation. But it is safe to assume that such cooperation will be limited. Leviathan may have reached its limits.

The world can look forward not so much to the triumph of the minimum state as to the global spread of the competitive, service-providing state. That may not be the revolution libertarians seek. But it will be better than what was on offer to most people throughout much of the 20th century.

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