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The future of fiscal federalism

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The Future of Fiscal Federalism

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1. Fiscal federalism and the welfare state

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

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

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

Musgrave's time, about a government's ability to play a successful stabilization role. See, for example, Tanzi, 2007.

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

However a half century ago many industrial countries started the move toward the creation of "welfare states" in which national governments would assure to the population minimum levels of particular public services. Social protection "from the cradle to the grave" became a goal for

[1] For example, in seventeenth century France "The principle was long established that each parish was responsible for its poor". See Solomon (1972) p. 22

[2] See Aikema and Meijers (1989), and Zamagni (2000), and Solomon (1972).

[3] As Solomon (1972) writes: "The primary question facing town councils all over Europe was not the Eradication of Poverty…but rather how to protect themselves against…armies of poor." p. 24.

many governments. Redistribution, that often meant improving Gini coefficients, became an objective distinct from that of helping the poor. The thinking of the time, reflected in Musgrave's book, made it clear that this social protection was a <u>national</u> responsibility towards what came to be seen as citizens' entitlements. This responsibility could not be fragmented among (or delegated to) sub-national governments because minimum standards were set nationally and because the welfare state was expansive and could be financed only or mainly by national taxes. It is no coincidence that this was the time when the (progressive) global income tax and the value added tax became the main sources of revenue in industrial countries. See Tanzi, 2006a. These taxes perform well when they are national taxes but less well when they become sub-national taxes.

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

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

At the time when Musgrave published his treatise, the cold war, between the West and the Soviet Union, was in full swing. 1959 was the year when the Soviet Union put Sputnik into space. The cold war divided the world into two competing camps. As a consequence there was, then, little interest in international cooperation and in creating supranational or truly global institutions, with strong powers, as there had been, briefly, immediately after World War Two when the Bretton Woods institutions had been created, the United Nations had been expected to play an important role, and philosophers and political figures, such as Jacques Maritain, Albert Einstein, Winston Churchill, Bertrand Russel, Mahatma Gandhi and others, were pushing for the creation of a federal world government that would be responsible for dealing with global needs. According to Wikipedia, the free encyclopedia, "the years between the conclusion of World War 2 and 1950… were the "golden age" of the world federalist movement." In that period opinion polls in several countries found that a world government was favored by majority of respondents. These countries did not, however, include the United States. The newly created United Nations and the Bretton Woods institutions, could have been the seed for this ambitious project.

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

The great expansion of the national government's economic role after World War Two, that led to a large increase in the share of public spending and taxes in GDP in most industrial countries,[4] did not and could not, displace completely the functions of local or sub-national governments. In several important countries—such as the United States, Germany, Brazil, India, Canada, Argentina, Switzerland, and others – intermediate, sub-national governments (states, länders, regions, provinces) had a historical origin: they had already existed in some form at the time of the creation of the larger national, political entities. Thus, for them the creation of national governments had been an act of fiscal centralization. Some of these intermediate, sub-national governments had strong political powers given them by the countries' constitutions. And some were as large as many countries. These powers essentially reflected political contracts, between the regions and the national governments, contracts agreed at the time of the countries' creation. These powers were not derived from decisions of the national governments. The existence of these "federal' arrangements had little to do with economics and much with politics. Economic justifications for fiscal federalism or decentralized arrangements provided by economists in recent decades were often ex post rationalization of existing, historical arrangements.[5]

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[4] For statistical evidence of that expansion see Tanzi and Schuknecht, (2000).

[5] See Oates (1972). Of course an argument could be made that when the countries are very large (Russia, China, Brazil, India, Canada, Australia, the United States) the regions themselves tend to be very large. For example, California would be one of the largest economies in the world, if it were an independent country, and the Chinese

(continued)

If instead of focusing on intermediate, sub-national governments (states, regions, länders, provinces, etc.) the focus were on municipalities, we ought to recognize that cities have existed, often as independent political entities (the city states) or as parts of larger political entities, for thousands of years. Except, perhaps, for capital cities, or for occupied cities, they have always had some degree of economic or fiscal independence and more justification for that independence than regions or provinces. Thus, they have always had some discretion in particular and traditional city-specific responsibilities. These responsibilities were and are important for the people who live in them.

In earlier times the responsibilities of the cities included the protection of their inhabitants from attacks and seiges from enemies. This created the need for walls and for other protective defenses and related expenses. Later, when the cities became parts of larger, national, political entities, this protective responsibility was transferred to the national government.[6] However, other important "public" functions remained the responsibility of municipal governments. Some were of an allocative kind; some of a redistributive kind. The redistributive responsibilities were shared with religious or other charitable organizations.

The allocative functions of municipalities included garbage collection, street cleaning, street lighting, the provision of sewers, drinking water, and municipal roads, the regulation and control

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provinces would be among the largest countries. In these cases a "unitary" government would make much less sense. In several cases, size imposes federal arrangements.

[6] It became the most important function of the national government.

of local traffic and some local economic activities (such as fairs, markets, and shops), the certification and licensing of some activities and economic agents, zoning regulations, some health regulations, and the promotion of local, cultural (and, originally, especially, religions) celebrations. In addition to the above, there were activities of a more redistributive nature related to the welfare of specific individuals or families such as the provision of public housing, rent controls and similar functions. Municipalities had always carried some responsibilities for the very poor including the very old. Municipal governments were there when everything else or other public institutions failed. Municipalities had better information on the immediate needs of individuals as compared with the general and abstract needs of categories that could be more easily assessed by national governments. City officials were nearer to the persons in need, at a time when travel was difficult and communications limited. In some ways, the welfare state shifted the focus of public attention from the needs of real, specific individuals to those of general categories.[7]

Historically, municipalities competed among themselves in various activities.[8] Especially in Europe, they also competed in the creation of monuments and buildings that provided a specific identity, and a sense of pride, to a particular city.[9] This cultural competition between cities is still significant today. These activities were financed by local fees and taxes, or occasionally by

[7] The growth of the welfare state started with the public assistance given to soldiers and public employees and gradually spread to other categories. It was not focused on the poor. See Ritter (1991).

[8] For fascinating historical backgrounds see Zamagni, editor (2000); Aikema and Meijers, editors (1989); and Solomon (1972). In Italy they still compete in the scope of religious celebrations for patron saints, which represent significant expenses, in fairs, and in the celebration of carnivals.

[9] For example the Tower of Pisa or the cathedrals.

contributions from rich residents. The taxes were essentially prices paid for collective services received. Thus, they had the rationale of benefit received taxation. The taxes were often of a "presumptive" or "forfait" nature including those levied on real properties (houses, land) or on economic activities (business taxes, fortait taxes). Cadastral values on imputed sales, or even space used, determined the tax payment. These taxes required low administrative costs but also provided low revenue. Inevitably richer cities could provide better services than poorer cities. However, movements by poor people from one town to another were discouraged.[10]

The creation of the welfare state increased the national governments' share in total public spending. Average tax levels increased sharply in many countries, because of the high cost of the universal public programs. Much of the increase occurred at the national level. This was a period of fiscal centralization rather than decentralization.

2. Fiscal Federalism and Reactions to the Welfare State

The optimism about the normative role of the state in the economy, that had pervaded Musgrave's time and his book, started to give rise, in the late 1970s, to growing skepticism and disillusion especially in Anglo Saxon countries. High taxes started to be seen to encourage tax evasion and underground economic activities, and to create incentives that had negative effects on economic growth.[11] Powerful and articulate political personalities, in the United States, the

[10] At times "licenses to beg" were required. See Solomon (op.cit) p. 30.

[11] Interestingly neither tax evasion, nor underground economic activities appear in the index to Musgrave's book or to other major public finance books of the time. Furthermore, the negative incentives associated with high marginal tax rates had been dismissed as unimportant by Musgrave and by other major economists until the late 1970s.

United Kingdom, New Zealand and other places, started promoting the view that the government may, at times, be the problem rather than the solution to problems. The school of public choice developed in this period. Concerns about the inefficiency of public spending and the welfare costs of taxation rose while macroeconomic problems appeared in the form of structural fiscal deficits, high and growing public debts, and stagflation. Since the growth of public spending had taken place mainly at the <u>central</u> government levels, it was natural that the reaction would be directed at that level.

The reaction against the excessive growth of public spending took two distinct tracks. One was the <u>privatization movement</u>. The other was the <u>fiscal decentralization movement</u>. The privatization movement started in the 1980s mainly in the UK and spread to other countries. It became particularly pronounced in the early 1990s when it was considered an important part of the so-called "Washington consensus". It reflected the view that many public sector activities could be delegated to an increasingly sophisticated private sector and that this delegation would lower the costs of production or provision and raise the quality of the services. It would increase a country's efficiency in the use of its resources thus giving the citizens more value for the money that they spent. Privatization could also provide badly needed, but once for all, public revenue. Some governments saw the privatization of the public enterprises (or of parts of them) mainly as a source of short-term fiscal revenue rather than as a way to reduce the role of the state in the economy.[12]

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[12] Some countries kept "golden shares" that guaranteed their continued controls over the presumably privatized enterprises.

In a privatized setting individuals would buy (from the private sector and with their own money) what they had been buying (or getting) from the government through the payment of taxes or, in some cases, low tariffs. Or the government would buy from private sector's providers what it made available to the citizens. The privatization movement started with the selling of whole or parts of public enterprises and, in some countries, it spread to the privatization of pensions, of some educational services, to the building of infrastructures (through the so-called public private partnerships) and so on. In this "privatization track" the change was mainly from the activities of the central governments to those of the private sector.[13]

The other track was fiscal decentralization. Fiscal decentralization would reduce the role of the central government and increase that of the lower levels of government (especially regions, states and similar), a change that those who favored this track considered beneficial.

This alternative was promoted by a new emerging literature and was justified on various theoretical grounds: it would increase the citizens' control over the decisions of distant political leaders. It was, thus, seen as being more democratic. It would lead to a more efficient use of resources, because the public services provided would be closer to those desired by the citizens, and the citizens of different jurisdictions might prefer different combinations of public output. Also, less convincingly, it was argued that decentralization would stimulate economic growth.[14]

[13] Interestingly an important Italian book, published in 1902, had made a similar case for the municipalization of public services. See Montemartini (1902). Montemartini believed that municipalities would be more efficient in the running of public enterprises.

[14] For a recent discussion of these views see Ahmad, Brosio and Tanzi (2007)

This literature was quite specific and detailed on the question of decentralizing spending and particular functions. However, it was far less specific on the question of decentralization of revenue.[15]

To a larger extent than realized privatization and fiscal decentralization are mutually exclusive alternatives. If some fiscal activities of the central government can be decentralized, in many cases they can also be privatized, or at least outsourced.[16] Thus, the question becomes whether the private sector or the decentralized public sector would do a better job in improving the welfare of citizens. Divergent political views, rather than hard evidence, often lead experts to prefer one option over the other. The private sector is often assumed to be more efficient in the use of resources because it is less affected by political interference. It can also produce the goods that citizens demand when they vote with their pockets. It can thus match its production to the specific needs of the citizens of a particular area, a characteristic that is supposed to be one of the virtues of fiscal decentralization. However, those who prefer fiscal decentralization call attention to public goods or to the externalities generated by some publicly provided goods or services; or alternatively, they call attention to equity aspects (i.e. access to services by people with low incomes), as reasons for preferring the fiscal decentralization alterative.

[15] This creates particular difficulties when the average incomes and the taxable capacities of different regions of the same country diverge significantly. Or when economies of scale in tax administration raise the marginal cost of collecting tax revenue at the lower levels. See Tanzi (2007).

[16] See Tanzi (2001).

As mentioned earlier, the decade of the 1990s saw a significant move toward privatization in many parts of the world. So called "natural monopolies" tended to disappear, in part because of technological developments that eliminated their monopoly characteristics; many public enterprises were privatized; the undertaking of major infrastructure projects were delegated to private enterprises through newly-created "public, private partnerships"; several countries allowed, or gave, a larger role to private pensions and private schools and some even privatized the army; several services (garbage collection, management of cemeteries, street cleaning and lighting, street repairs, local public transportation, etc.) were privatized or outsourced. Technological developments and pressures to provide more value for money facilitated or promoted these developments. "National champions", that had enjoyed government provided monopoly power, were challenged by private competitors which were increasingly foreign owned.

The turn toward privatization was accompanied by a growing interest, on the part of many economists and politicians, in the alternative of fiscal decentralization even though this was generally not seen as an alternative to privatization. The privatization alternative was not favored by some because of the belief that (a) some activities must remain public because citizens are entitled to the free (i.e., tax financed) provision of particular services; (b) the private sector can be inefficient when it is not competitive or well regulated;[17] and (c) because poorer citizens would not have the means to buy some needed services if these were privately provided.

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[17] This was the argument made in 1902 by Montemartini (op.cit) in support of the municipalization of public services. Of course, private markets are more efficient today than they were at that time.

Widely publicized failures on the part of some privatized activities, and the exploitation of those failures by representatives of public sector employees, made fiscal decentralization appear for some as a preferable to privatization.[18]

3. Fiscal Federalism and Globalization

The trend toward privatization or fiscal decentralization was taking place at a time when the world was undergoing a period of intense globalization. Globalization has many meanings but in essence it implies that: many previously local or national activities have become global or international in scope; global public goods (or public "bads") have become common; the international distribution of income has become a significant element in the economic discussion partly because of its implication for, often illegal, migration flows; the need for global regulation of some activities has increased. Some public goods, being global, require global rather than national financing. It is not too farfetched to assume that the globalizing world would need a global government (or a proxy for one) in the same way in which governments were needed in nations. If a plausible case for a global government existed in 1950, there would be a far stronger one now.[19] The obvious political obstacles to it do not diminish the theoretical need for it. The normative case for a global government is strong. The likelihood of its becoming a reality is a different story. Let us mention some developments that point to the need for a

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[18] In spite of overwhelming evidence that privatization has often reduced the prices of services and improved the quality, surveys in some parts of the world (e.g., Latin America) indicate strong negative reactions to it.

[19] An article in Wikipedia mentions that the idea of a global government is not new. It was discussed by the Greeks and the Roman and advocated by Dante in 1397 in his book, Monarchia. The idea attracted many followers especially after the Second World War.

meaningful global authority or authorities. These developments could also be organized along the traditional functions of allocation, distribution and stabilization.

As a reflection of technological and policy changes, the financial system has become truly global and the need to regulate it globally has become evident to many. See Schinasi (2006). The prescription of Basel II and the increasingly forceful calls by the European Central Bank, the German government and others to regulate hedge funds and to strengthen international payment systems are indication of it. There is also a lot of talk about changing the Architecture of the International Financial System. See inter alia, Tirole (2002).

Transportation systems (planes, ships, trains, trucks) no longer cover just the territory of one country but have become international. As a consequence they require agreements relating to rules that coordinate the activities and operations of companies and vehicles registered in particular countries but operating internationally. Various agreements have been reached to facilitate these international activities. There is a growing need for global regulatory authorities in several related areas.

International trade has grown spectacularly and has led to the need for institutions (such as the WTO) that establish rules for trading nations and arbitrates conflicts when they arise. The debate about the trade of genetically modified agricultural commodities or of products from endangered species or defective in other ways are examples. The historical discretion enjoyed in the past by individual countries is no longer desirable or possible.

Because of globalization -- that brings an increasing number of people of different countries into frequent contacts -- and because bacteria and viruses do not recognize national borders, the spread of contagious diseases is increasing at an "unprecedented rate" according to the World Health Organization.[20] The need to coordinate the activities of national health authorities has become obvious and urgent. Therefore, it would be wise to increase the role and the power of the World Health Organization. The no-longer distant possibility of deadly pandemics has been giving urgency to global plans and coordinated reactions to this challenge. Independent national responses are no longer adequate.

Like viruses, criminals now cross frontiers with increasing frequency. International crime and terrorism are creating the need to coordinate the activities of police forces and security institutions, while giving increasing power and resources to Interpol and other similar international institutions. See Tanzi (2001); Masciandaro (2004) and Naim (2006). An International Criminal Court with international scope is already in existence.

Money laundering, facilitated by global aspects of the financial system, has become a major world problem leading to calls for institutions with a global reach. See Masciandaro et. al. (2007).

[20] As the director of the Insects and Infectious Diseases Unit of the Pasteur Institute in Paris has put it: "We are in a world where things are whizzing around so fast we inevitably are going to see more and more [spread of diseases]". Reported by Bloomberg (Sept. 24, 2007).

Developments in particular parts of the world (Darfur, Kosovo, Afghanistan, Iraq, Lebanon) have significant spillover effects that require, or call for, the attention of the international global community.

Tax systems are more and more affected by tax competition or by attempts on the part of some countries to export their taxes. The taxation of multinational enterprises, or of individuals who operate in different countries, require coordination among countries, either through expanding the reach of existing international institutions (EU, OECD) or, preferably, through a World Tax Organization that would be able to propose rules, coordinate discussions, prepare periodic fiscal development reports for the world, encourage exchange of information among countries, and, if the time comes, collect global taxes that could finance global goods. See Tanzi (1999a). Proposals that would introduce international or global taxes, as for example pollution charges or variations of a Tobin tax, are getting increasing attention.

Particular “research activities” (especially in the atomic or biological area) in particular countries have become global concerns thus creating a need for monitoring by the world community. The likely spread of use of atomic plants to produce increasingly scarce energy will increase this need. The role of the International Atomic Energy Agency is likely to increase in importance.

Exchange rates, interest rates, or foreign investment actions have become global concerns.[21] Action (or lack of action) on the part of important countries (China, the United Sates, Japan) in particular areas, such as exchange rate movements or trade imbalances, has implications for other countries thus requiring again a coordinating role on the part of some international institution (IMF?).

Pollution is no longer a national "public bad" when it affects global warming or the health of citizens in other countries. Global warming could become a negative externality of biblical proportions that could bring frictions and major crises. It can only be addressed globally. For all its shortcomings, the Kyoto Agreement was an example of an attempt at global coordination in this area.

There is a need to coordinate the use of intangible capital and for a global institution to register and grant patent rights, copyrights, and trademarks and to adjudicate disputes in these areas. Infringements of intellectual property rights are creating growing frictions between countries.

The need to coordinate the use of water and access to energy sources is becoming obvious. For example, there is growing attention and claims over parts of the Arctic because of the energy sources that it may contain. Water wars are being widely anticipated unless potential disputes are settled peacefully.

[21] For example, the operations of sovereign investment funds are being scrutinized and calls for regulating them are becoming more frequent.

Wide differences in income levels in different regions of the world are creating huge (and often illegal) migratory flows across countries. The need to coordinate policies to respond to these flows is becoming obvious. Within the United States and Europe, migration has led to major political debates. Once again, national responses (or, in the USA, state responses) are no longer sufficient.

Even the function of economic stabilization is moving from the national to the international sphere because the power of national governments to pursue stabilization policies is falling as economies become more open and financial markets become more global. There is increasing talk about coordinating demand management policies at an international level.

The above are far from exhaustive examples of processes or activities that are becoming global and that are requiring international responses or actions. When public goods or externalities exist within a country, they often justify the intervention of national governments. When they become global, they would justify the role of a global government if it existed. In the absence of a global government, they require some delegation of (central) national government power to international organizations or international agreements or even to understandings that restrict national actions. Google lists about 200 international organizations in existence today but their number is much higher. Thus, we are long past the world contemplated by Musgrave in 1959. Economists need to wake up to the new reality and reflect it in their work. That reality is that, with the passing of time, the power of national governments to make decisions is being constrained by the power given by these governments to international organizations and international agreements.[22] This new reality is becoming most obvious within the European Union.[23] The literature on fiscal federalism must recognize these developments. They are more important than the question of which level of government, within a country, should do what. Whether the new reality can be assumed to reflect the existence of a global government is a semantic issue. There is no doubt that responsibilities and powers are being progressively shifted upward, whatever we call the higher level.

4. Concluding Remarks

A keynote speech at a major conference on fiscal federalism could have dealt with the rich, growing and technical literature on the topic. It could have stressed interesting issues such as what Oates (2006) recently called "the dark side of fiscal federalism." That "dark side" has stressed that the reality of fiscal decentralization can be very different from the idealized theory of it. However, it might be more useful to stress two large gaps in the fiscal federalism literature: the link of prevailing views on fiscal federalism to historical development; and the de facto on-going, step by step creation of a layer of government, or a power, above that of national governments. We have been spending too much time looking down from the central government's layer. It is time to look up from that layer.

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[22] This development will be felt with increasing intensity as the United States loses the hegemonic power that it has enjoyed in recent decades. In a world with several poles, the need for global coordination will become greater.

[23] See J. Pisani-Ferry and A. Sapir (2007); European Commission (2002); UK Cabinet office (2007).

The historical link is important because it largely determines the relations or arrangements that exist at a given time, within a country, among the various layers of governments. On these relations the views of economists, unfortunately, have little impact. Fiscal arrangements are largely political contracts made at particular times and reflecting the political conditions prevailing at that time. These contracts come under considerable stress when political views, intellectual winds or technologies change. Arrangements that may have looked optimal at the time they were made may no longer look so at later times. For this reason, it seems superficial to talk about "optimal fiscal arrangements" within countries without relating them to a specific time period.[24]

When constitutional arrangements exist that make changes difficult, as in the United States, they cannot prevent the creation of stress or tensions among the different levels. In these circumstances a respected and competent arbiter, such as a powerful Supreme Court, can help to adjudicate disputes and thus preserve the arrangements in spite of the stress. Supreme Courts have been playing progressively larger roles in countries such as the United States and Brazil that have long-established federal structures. Stress can, of course, relate to taxing and spending decisions that have attracted much of the attention of economists working in the area of fiscal federalism. Or it can relate to regulations. A role of the state that comes to depend less or spending and taxing and more on regulations will face regulatory inter-jurisdictional conflicts with increasing frequency. Regulations related to particular activities are the area in which the

[24] This is especially relevant to concepts such as that of "fiscal equivalence".

greatest tensions, between national government and states, are most evident in the United States.[25]

The progressive, de facto, creation of a super national or global layer is the other area calling for attention. This development has not received the attention of scholars that it deserves except within the European Union in which the super national layer is most obvious and is progressively becoming more important in spite of the resistance of some national governments.[26] The fiscal federalism literature needs explicit analyses that deal with this aspect that is one of the most significant developments in fiscal federalism at this historical juncture. There is need for theories that deal with the role and the form of "global governments", whether these are de facto or de jure governments, and whether they govern with spending and taxes or, as is more likely, with regulations or other softer tools.[27] If current trends continue, as they seem likely to, what should be the role of international institutions, agreements, understandings, soft laws, informal agreements and so on vis-à-vis the traditional government functions of stabilization, distribution of income, and allocation of resources? How should these institutions be monitored and financed? What controls should the national governments continue to have over them? At this

[25] See tensions related to abortion rights, same sex marriages, stem cell research, the environment, allocation of water, immigration, safety standards, and so on. California has sued the federal government to force a decision on whether the state of California can impose emission standards for cars and trucks. In some federal countries, such as Brazil and Mexico, tensions often relate to fiscal issues. In Mexico more than 90 per cent of all cases that go to the Supreme Court are tax cases. In Brazil a tax lawyer is essentially a constitutional lawyer.

[26] The New Treaty agreed in Lisbon in October 2007 dealt with this issue even though there is great reluctance to talk about a super state.

[27] The reluctance to call the supra-national structures "government", implies that they will have more regulatory than spending power than might be optimal.

moment (November 2007) the latter is a major issue at the IMF, the international institution most concerned with the function of economic stabilization at the global level. See Truman (2006) and Tanzi (2006b). For the EU, see the just published book edited by Pisani-Ferry and Sapir (2007). These issues should definitely be part of a "New Perspective on Fiscal Federalism".

Within the context of the European Union, Pisani-Ferry and Sapir have identified three models for governance by national governments over international institutions: (a) unconditional delegation; (b) supervised delegation; and (c) coordination. "Supervised delegation" implies a multi principal-agent approach where the principals are the many national governments and the agent is the European Union. In the EU context, the national governments are those who belong to the EU. In a global context it could be the governments of the whole world.

Supervised delegation raises immediately the question of "to whom to delegate"? "With what incentives?" "With what voting procedures"? Problems of "mission creep", among those to whom the functions are delegated must be faced.[28] The question of incentives and "mechanism designs" (using the terminology of the 2007 Nobel Prize Winners in economics) is clearly important. What incentives will make the delegated institutions mobilize the internationally dispersed knowledge to achieve optimal results? And what controls would the national government continue to have over the supra national institutions? One country, one vote? Votes reflecting populations, or economic powers? Would there be the equivalent of "constitutional

[28] This problem of mission creep is inevitable when the responsibilities of two institutions (say the World Bank and the IMF) intersect at some point. The problem exists also between different layers of government, say states and national governments.

limits?" How frequently would the voting powers be changed to reflect the changes in the variables that determine voting power? What would be the mechanism for change?

Once functions are assigned to international institutions, what about the resources needed to pay for their activities? Would the financial contributions parallel the voting powers? What about problems of legal accountability? Accountability in the use of funds? Accountability in the outcomes? The parallels between these issues and those raised in the fiscal federalism literature are immediately recognized.

In a future world with global arrangements, how much power will or should the national governments continue to have? What role should be delegated to regions and provinces? Should the national government continue to be the sole interlocutor with the international or global institutions? There is growing evidence that regions or "states" begin to play some role in these relations. For example the government of California has been discussing environmental issues directly with the European Union and some states have established de facto embassies in foreign countries. Should these issues remain the exclusive prerogative of the U.S. Federal Government and of other national governments?

A decade ago I predicted that, with the passing of time, the importance of municipalities would grow, because that is where people now live. As per capita incomes grow, people become progressively more concerned about the quality of life in the places where they live. The quality of life is a superior good the demand for which is likely to grow faster than money income. The role of municipal governments in promoting that quality is obvious. There are now surveys that rank cities with respect to the quality of life that they offer their residents. People operate more and more globally but they care about the quality of life of the specific areas where they and their families live. Cities compete to attract high-income people. They do so through the amenities and the services that they offer.

I also predicted that national governments would lose importance because of the delegation of some of their powers to international or global institutions. (See Tanzi, 1999b). These governments may also see their roles reduced because of the likely scaling down of some of their expenditures connected with the welfare state because competition from low taxed, emerging markets will force them to reduce their taxes. Nothing that has happened in the last decade has made me change my prediction. But it is not clear as to what would happen to regions and provinces, especially in countries where hard-to-change historical, constitutional arrangements guarantee the regions specific roles.

As Spolaore's paper (2007) indicates that it has been happening, and as I argued in a paper on decentralization a few years ago (Tanzi, 2001b), in this new environment the world may witness more splitting of countries, when the citizens of a region disagree strongly with the policies of their national governments; or when, for cultural reasons, they feel different. Fiscal decentralization has aimed at reducing this incentive. Globalization and the creation of a de facto global governance make it easier for small territorial entities to operate as new independent countries and as full members of the international community. Small countries can do well in a globalized world, where the dangers of foreign invasion are greatly diminished and where open borders reduce the importance of national economies of scale. A danger associated with this trend is that it may encourage rich regions to become independent so as to no longer contribute to the public expenses of poorer regions. The push for decentralization toward regional government in the past couple decades may have been partly stimulated by this goal.

In conclusion we may look forward to a world with an increasing number of countries, a growing supra national structure, and with more important municipalities. Economists interested in fiscal federalism should address these developments and pay to them the attention that they merit.

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