INVITED POLICY PAPER

Social Protection in a Globalizing World*

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Gli strumenti adottati dai governi nelle economie di mercato, nel loro tentativo di migliorare la tutela dei singoli individui attraverso azioni di governo, sono essenzialmente tre: (a) programmi pubblici finanziati da sovvenzioni pubbliche, (b) "incentivi fiscali", (c) varie forme di regolamentazione. Questo saggio analizza come questi mezzi promuovono la tutela sociale e quale impatto abbia la globalizzazione — nelle sue varie forme — su tali strumenti.

The instruments used in market economies by governments, in their attempt to enhance the protection of individuals through governmental actions, are essentially three: (a) public programs supported by public spending; (b) "tax expenditures"; and (c) various forms of regulation. In this paper, I will discuss the use of these instruments in promoting social protection. I will then assess the impact that globalization, in all its manifestations, might have on these instruments. [JEL Code: H11 - H55]

1. - Introduction

Social protection (or social insurance) broadly defined is a European invention. Its introduction can be traced back to the "Workmen's Compensation for Norwegian Miners", enacted in 1842 for the protection of miners; or, perhaps, to the introduction by Bismarck of a national insurance system in Germany in the

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1880s. Both of these legislations covered a relatively small proportion of the population. The "New Deal" introduced in the 1930s in the United States by President Roosevelt, or the welfare program introduced by Juan Perón in Argentina after 1945, were later adaptations, to a larger proportion of the population, of the European invention. These and similar legislations that introduced systems of social insurance, including public pensions, were compulsory and were administered by the state.

All European countries and many other countries around the world now provide, for workers, old age and survivors' pensions as well as compensation for work-related injuries and for disabilities. In this paper, I discuss social protection in a broad sense: that is, the discussion is not limited to pensions. Social protection covers various policies adopted by governments to protect citizens against several risks with economic consequences; or at least policies adopted to help citizens to better cope with these risks.

A broad survey of industrial countries indicates that the systems of social protection have developed along different directions in groups of countries. In some of these countries, the protection that the systems provide is much deeper and broader than in others. In some of them, as for example in Italy, social protection is largely limited to the provision of pensions. Furthermore, the instruments used to provide the social protection have, to some extent, diverged across groups of countries.

The instruments used in market economies by governments, in their attempt to enhance the protection of individuals through governmental actions, are essentially three: *(a)* public programs supported by public spending; *(b) "tax expenditures"*; and *(c)* various forms of regulation. This classification may seem strange because most observers identify social protection exclusively with public spending. In the rest of this paper, I will discuss the use of these instruments in promoting social protection. I will then assess the impact that globalization, in all its manifestations, might have on these instruments.

2. - Social Protection Through Public Spending

Social protection has generally been identified with public spending and, in its more advanced form, with the welfare state. Its financing requires a higher level of public spending and consequently of taxes than in countries that do not pursue this goal through public spending. In the case of welfare states social protection requires high spending levels. Although the concept of the welfare state developed in the first half of the 20^{th} Century, it was only after the Second World War, that it was put into practice when several European countries, and perhaps Argentina and Uruguay, developed various forms of welfare states. The Nordic countries of Europe, together with France and a few others, went further than other countries in their stated goals of protecting individuals "*from the cradle to the grave*" against economic risks. This protection was provided through programs that required public spending.

In these welfare states, the state guarantees for most or all citizens minimum pensions and free, or heavily-subsidized, health and educational services. It provides allowances to families with children and assistance programs for the very young, the very old, and those with particular handicaps. The social insurance systems of these welfare states provide benefits that are, for the most part, *comprehensive* and *universal*. These benefits are not subject to means tests, except for particular benefit such as public housing.

Being universal, these programs require high levels of public spending. In 2004, the share of public spending of the general government into gross domestic product exceeded 55% in Sweden and Denmark and 50% in France, Finland, and Austria. Ten years earlier these proportions had been much higher having exceeded or approached 60% of GDP in Sweden and Denmark. In 2004 in Italy that share was marginally above 48%. In Italy this high share was partly due to the interest payments on the large public debt and the exceptionally high level of pension payments.

In several of these welfare states, apart from pension payments, children allowances, and unemployment compensation which obviously come in the form of cash payments, the social protection provided by the state can also be *in kind*. It involves the provision of direct government services. It is, thus, associated with a high share of "*real*" or "*exhaustive*" public expenditure in GDP. The provision of these services (public health and education, assistance to the aged, assistance to the young, to the handicapped, etc.) requires the direct use by the government of real resources and more public employees. As a consequence, a large proportion of the potential labor force of these countries must be employed by the state to provide these services.

In some of these countries, such as Sweden, as much as 30% of the labor force works for the government compared with about half that number in Italy. Many of these public employees, in addition to their role in the provision of health and educational services, are used in activities that deal with child care centers, old age homes, in-house assistance for the elderly and the chronically ill, public housing, and so on. Many of these public employees are women. Thus, the welfare state has created working opportunities, within the public sector, for women. It has also liberated them from the need to deal with old or handicapped relatives. It has sharply raised the labor force participation of women. Compare for example the women's labor force participation of Italy with that of Sweden and Denmark. The Swedish and Danish participation in 2003 at 71.5 and 70.5%, compared with the 42.7% participation in Italy

A welfare state of the type described above has, inevitably, positive and negative effects on society and on the economy. A full discussion of these effects is beyond the scope of this paper but a mention of some of them should be made.

Among effects that most observers would consider positive are the following:

(a) An after-tax income distribution that, compared with other countries, is more even. The Gini coefficients of these welfare states are among the lowest in the world.

(b) As already indicated, a high participation rate in the labor force, especially for women. The participation rates in these countries are among the highest in the world. Women in particular find more opportunities to work. This is undoubtedly a liberating experience for some of them.

(c) A tight safety net for individuals. Few fall through the net because society is willing to support those who are exposed to greater economic risks. Ethnically homogeneous societies, such as those of the Scandinavian countries, make this support for the unfortunate among them more acceptable for the average citizen even though it comes at a high financial cost. It has been argued by some economist, such as Hans-Werner Sinn, that this safety net may encourage individuals to take greater economic risks in their economic activities because they know that if their gambles do not succeed, society will take care of them. Risk taking in economic activities is assumed to promote economic growth.

(d) Good education and health standards. In a world where human capital has become a major ingredient of productivity growth, the availability of a highly educated and healthy population has allowed these countries to be competitive internationally in spite of their high tax burdens. These countries have some of the healthiest and best educated populations in the world. Still, it is important to report that some of the countries classified as welfare states have seen it necessary to significantly reduce the share of their public spending into GDP in recent years[1]. See Table l.

The group of ten countries reported in Table 1, some years ago had an average level of public spending, as a share of GDP, of 55.3%; by 2002 this share had fallen by a remarkable 11.7% of GDP from the average of the highest spending levels achieved in the past[2]. While for some of these countries part of the fall was due to savings in interest payments that accompanied the fall in inflation in recent years, a large part was due to the retrenchment in the role of the state in the economy. This was the result of specific policy decisions.

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[1] See SCHUKNECHT L. - TANZI V. (2004). They have also sharply reduced some of the inefficiencies associated with the tax system, have reduced the number of regulations, have encouraged spending on research and development, have introduced budgetary systems that do not tolerate inefficiency in public spending and have carried out other important structural reforms.

[2] Please note that the highest spending levels were not reached in the same year for these countries. So that the average of 55.3% does not refer to a specific year.

TABLE 1

HIGHEST AND 2002 SHARES OF PUBLIC SPENDING
(Percentages of GDP)

Country	Highest Level and Year Reached	2002 Level
Norway	52.0 (1992)	42.3
Sweden	67.5 (1993)	52.6
Canada	49.9 (1992)	38.2
Belgium	57.1 (1985)	46.2
Netherlands	53.3 (1987)	41.8
Finland	59.1 (1993)	45.2
Denmark	58.9 (1996)	50.1
Austria	53.3 (1993)	48.8
Ireland	50.7 (1985)	31.8
New Zealand	51.8 (1986)	39.0
Average	55.3	43.6

Source: Adapted from OECD data.

(e) Generally low crime rates, except for violent crimes attributed to heavy drinking and, increasingly, for crimes attributed to, or blamed on, immigrants.

Among the effects that could be considered negative must be mentioned the following:

(a) High levels of public spending require high levels of taxation. High tax rates have inevitable welfare costs that may rise in a globalizing world where some tax bases acquire greater elasticity. I shall come back later to this aspect. High tax rates distort the allocation of resources and reduce work and saving incentives.

High tax rates have been blamed for the emigration of financial capital, of some enterprises, and of highly talented and high income individuals. These countries have tried to reduce these disincentives by reducing the high marginal tax rates and by improving the quality of their tax systems. For example, the Dual Income Tax, that sharply reduced the rate at which financial capital is taxed, was first introduced in the Scandinavian countries to alleviate this problem. Also the highest rates on personal incomes have been sharply reduced. These rate reductions have been compensated by the broadening of the tax bases in order to limit their impact on revenue.

(b) The large allocation of human and financial resources to activities that have low economic, if not social, value. Resources allocated to social services, especially those directed towards the care of the very old, in spite of their high human value, do not contribute to economic growth[3]. These government-supported activities have replaced some household production. By doing so they may have distorted the comparability of international statistics on per capita incomes. The reason is that while, for example, in countries such as Sweden and Denmark these activities are counted in the national income statistics, because they take place outside the household, in Italy similar activities take place within the household and are not counted in the statistics. In Italy the very old are generally taken care of within the family by unpaid relatives while in Nordic countries they are often taken care of by paid strangers. This results in very different public spending in the two countries for this function.

(c) An important effect often ignored in these discussions is that the explicit and massive entrance by the state in the last century in the field of social protection must have displaced other forms of social protection that existed before that entrance. In a way in some countries the state created a monopoly in this area and reduced the incentives for private groups to play a role. It is a mistake to assume that the state came in to fill a total vacuum or that, before the state intervened, there was no protection for unfortunate individuals against particular economic risks. The state certainly added to and formalized the protection against these risks. But we must recognize that a lot of protection already existed and was probably crowded out by the state intervention.

Informal forms of social protection had been provided, before the creation of welfare states, by the (extended) family, by the churches, by religious orders, by local community organizations,

[3] However, an argument could be made that if the alternative use of these human resources would have been to be unemployed then society may gain from their social use.

by fraternal societies, by neighboors, and so on[4]. Thus, to some extent, the state replaced, or crowded out, voluntary and informal assistance. It replaced the existing system of voluntarism based largely on informal means tests with a system based on legal entitlements. The government programs to which citizens are now entitled as a matter of right, replaced the, undoubtedly uncertain and incomplete, networks, of traditional social protection[5]. This implies that the net gains in effective, social protection provided by public institutions may be somewhat smaller than could be assumed by the statistical information of how much the government spends for these activities. Unfortunately there is no way of measuring these net gains.

Even ignoring the above point, (about public protection replacing voluntary protection), another point needs to be made. Some statistics, estimated by the OECD, have provided *gross* public spending on social protection and net social spending, both as shares of gross domestic product. See Table 2. It is gross spending that generally attracts attention. However, after adjusting the gross public spending on social protection for the effect of taxes on benefits received, such as those on pensions and on unemployment benefits that are taxed in some countries and not in others, and adjusting for mandatory social spending by enterprises, and for mandatory private social spending, the net social expenditure indicators diverge less than the gross indicators.

Table 2 provides the available information on gross public social expenditure, gross total (i.e., public and private) social expenditure, and net social expenditure indicators. There are obvious large differences among the countries. Ignoring Korea and Japan, gross public social expenditure as a share of GDP is as high as 31.8% in Sweden and 30.7% in Denmark and as low as 14.7% in the United States and 17-18% in Australia and Canada. However, these differences are much reduced when mandatory

[4] Especially in Italy, the church, with its network of monasteries and religious orders, and some of the city states, such as Venice, had played over the centuries a large role in providing social protection. See ZAMAGNI V. (2000).

[5] In Italy this network has continued, though in a diminished form, because a full welfare state never came into existence.

TABLE 2

GROSS TOTAL SOCIAL EXPENDITURE, 1997
(Percent of GDP)

Country	Gross Public Social Expenditure	Gross Total Social Expenditure	Net Social Expenditure [1]
Australia	17.4	21.7	21.9
Austria	25.4	27.0	24.6
Belgium	27.2	29.5	28.5
Canada	17.9	22.1	21.8
Denmak	30.7	32.0	27.5
Finland	28.7	30.0	25.6
Germany	26.4	28.6	28.8
Ireland	17.6	19.2	18.4
Italy	26.4	27.8	25.3
Japan	14.0	14.9	15.7
Korea	4.3	8.4	8.6
Netherlands	24.2	29.1	24.0
New Zealand	20.7	21.3	17.5
Norway	26.1	27.2	25.1
Sweden	31.8	34.8	30.6
United Kingdom	21.2	24.9	24.6
United States	14.7	22.9	23.4

(1) Percent of GDP at factor cost.
Source: Adapted from several tables in Willem Adema, Labor Market and Social Policy - Occasional Papers no. 52. Net Social Expendture, 2nd Edition, OECD DEELSA/ELSA/WD (2001)5. August 29, 2001.

social spending by the private sector and taxes on social benefits are considered. Table 3 shows that this adjustment reduces the difference between, say, Sweden and the United States from 17.1% of GDP to 7.2% of GDP; and that between Denmark and the United States from 16% of GDP to 4.1% of GDP.

(d) Over a long period of time, a highly developed system of governmentally-sponsored social protection must have an impact on the psychological make up of recipients. For example, in the United States, a country that is not considered a welfare state, the welfare program for poor families introduced in the 1960s by the Johnson Administration, the so-called "*War on Poverty*", has been reported to have reduced the participation of the poor in the labor force from 72% to less than 50%. By the middle of the 1990s some families on welfare had no family members that had ever worked.

TABLE 3

SOCIAL EXPENDITURE FOR SELECTED COUNTRY GROUPS, 1997
(percent of GDP)

	Gross Public Social Expenditure	Net Social Expenditure Indicators	Difference
Scandanavian Countries			
Denmark	30.7	27.5	–3.2
Finland	28.7	25.6	–3.1
Sweden	31.8	30.6	–1.2
Average	**30.4**	**27.9**	**–2.5**
Anglo Saxon			
Australia	17.4	21.9	+4.5
Canada	17.9	21.8	+3.9
United Kingdom	21.2	24.6	+3.4
United States	14.7	23.4	+8.7
Average	**17.8**	**22.9**	**+5.1**

Source: Adapted from Table 2.

Clearly the incentives to look for work and to try to get out of the welfare trap had been affected. This program was modified by the Clinton Administration to make it more restrictive and to create incentives to move out of welfare[6]. Similar reactions have been reported in Sweden and Denmark where absenteeism from work and other abuses have been reported to be on the rise.

(e) When government programs crowd out voluntary contributions to social protection, and when the government comes to be seen as the only way to deal with a social problem, there may be significant, long run effects on society and on the economy. These effects may be less important in ethnically homogeneous countries that can apply moral pressures on the citizens that abuse the system. They are likely to be more important in countries with ethnic diversity or in those where rapid immigration is changing the composition of the population.

[6] One could speculate that high pension benefits received at a low pensionable age, as in Italy, may have the same impact on some members of the pensioner's family.

For this reason immigration has started to change the social attitudes of the populations of the countries that had gone furthest in creating mature welfare states. The citizens of these countries have become more critical of welfare programs that encourage ethnically different people to emigrate to their countries and take advantage of their welfare programs. See Sinn and Ochel (2003).

(f) Finally, among the negative effects one could add the impact that welfare states have on the family. There is no question that a mature welfare state, by increasing job opportunities for women, by removing the need to rely on family members for assistance, in old age and in illness, and by creating a social security that no longer depends on the family, reduces the economic importance and the social role of the family. This aspect is likely to be seen as a negative one in Italy but, it must be recognized that citizens of other countries, and probably some Italians, would consider it as a positive effect of the welfare state.

3. - Social Protection through "Tax Expenditure"

Social protection can be and has been, promoted through manipulations of the tax system. The tax system can be linked to social protection through its tax level, its tax structure, and, especially, through "tax expenditures". A high level of taxes helps finance public spending oriented towards social protection. The structure of the tax system can be and is often adjusted to make higher income people bear a high proportion of total taxes paid. For this reason progressive income taxes are preferred, on equity grounds, over taxes on consumption. However, a strong movement towards flat-rate taxes in recent years indicates an erosion in this preference for progressive taxes[7]. "Tax expenditures", or targeted, tailor-made, provisions of the tax system, can be used to promote certain types of private spending (including that for private pensions and for health) that increase protection against economic risks.

Tax expenditures have been receiving increasing attention

[7] See THE ECONOMIST (April 16th-22nd, 2005, pp. 59-61).

since the concept was introduced in the 1960s. They represent tax savings obtained against particular types of private spending. Now several countries estimate a tax expenditure budget every year. Public finance experts are aware that tax expenditures can be a substitute for public spending in the promotion of social or economic goals. That is, tax expenditure can promote results broadly similar to those of public spending.

In the past, tax expenditures were mostly tax incentives used to promote the *economic* activities of enterprises. However, in more recent years the focus changed and tax expenditures were used more frequently to promote *social* goals. These socially-oriented tax expenditures have grown in importance in several countries, including the United States and the United Kingdom. They are also important in Italy where the tax reform proposed by the Berlusconi government in 2002 aimed to increase their importance by listing many socially-oriented expenditures, or characteristics of taxpayers, that would justify the granting of tax expenditures.

Tax expenditures have been used by various countries to encourage more private spending (or reduce the cost of that spending) in health, pensions, charitable contributions, education, housing, expenditures on children, and so on. When tax rates are high, the value of these tax expenditures can be significant. The progressivity of the income taxes implies that the value of these tax expenditures tends to be higher for higher income taxpayers. However, they can be limited to incomes below a given level; or their value can be made to fall with the increase in the level of a person's income (vanishing deductions); they can also be given in the form of credits against tax payments rather than deductions from income.

When, for political or other reasons, such as limitations imposed by fiscal rules, there are constraints on public spending in a country, tax expenditures may become a preferred instrument. This is reported to have happened during the Clinton Administration in the United States. At that time the control by Republicans of the U.S. Congress made it difficult for the Clinton Administration to introduce spending programs that the administration favored. Thus, the alternative of cutting taxes to encourage certain types of private spending became attractive. The

Republicans in Congress were willing to go along with a policy that could be claimed to be a tax cut. Eric Toder, a tax specialist who looked closely at these developments, concluded that tax expenditures increased sharply during this period to reach about 5% of GDP. See Toder (2000).

In Italy developments over years in the structure of the Imposta Comunale Sugli Immobili (ICI) indicate that this tax has been slowly adapted to promote presumed social needs. These developments have progressively transformed a tax that should be essentially a tax *ad rem* into a tax *ad personam*. Reports from the United Kingdom indicate that in that country tax expenditures, to support various forms of social spending, have grown in importance over the years. Tax expenditures can play an important role in promoting private pensions. Private pension funds can be stimulated by a careful use of tax expenditures. For example Individual Retirement Accounts (IRA) have been stimulated in the United States by their tax treatment.

It is obvious that this instrument cannot be targeted precisely and thus, it represents an imperfect approach to social protection. However, there is no question that it can reduce the amount of public spending that a government would need in the absence of tax expenditures. In principle tax expenditures could reduce the need for universal programs so that a country's social spending could become more targeted towards those who are in greater need for social protection. This alternative, may in some cases, be preferable to one that relied only or mainly on public spending. However, its impact on the tax system must be considered. A tax system with many tax expenditures becomes more difficult to administer and its tax incidence more difficult to assess. Also the trend towards flat-rate taxes may reduce the effectiveness of this instrument.

4. - Social Protection Through Regulations

Is it possible to pursue the objectives of a welfare state through regulations? Or, putting it differently, is a regulatory welfare state possible? The answer is that it is possible, to some extent. Public spending for social protection and tax expenditures can, to a considerable extent, be replaced by well targeted regulations. Through these regulations the government can direct individuals, enterprises and the market towards specific social goals. In a market economy the government could, for example impose on private enterprises to have on its workforce a given proportion of handicapped, older workers or widows. Something similar happened in centrally planned economies where, for example, enterprises were directed to absorb all the workers that became available. As a consequence there was no official unemployment in these countries.

Obviously many existing regulations have little or nothing to do with the promotion of social protection. But many do. Here we focus on those that conceptually can replace public spending or even tax expenditures in the promotion of social protection. Examples of such regulations are:

(a) Labor regulations: Government regulations that establish minimum wages; limitations on firing; life contracts; rules related to working conditions, such as vacation time, length of the working week or working day; rules that require employers to provide insurance for workers or that require the employers to contribute to their pensions; rules that require enterprises to hire minorities or people with handicaps.

(b) Housing regulations: rent controls; rules on length of contracts; rules related to regaining possession of houses that have been rented out. Regulations that reduce property rights and that bias rental contracts in favor of the tenants.

(c) Banking and Credit Regulations: especially those that compel banks to provide subsidized credit to particular categories of borrowers such as students, farmers, small enterprises, etc.

(d) Regulations Through Public Enterprises: on hiring; on the provision of services at subsidized prices; on the provision of services to uneconomical areas, etc.

(e) Other regulations such as "affirmative actions" dealing with the disabled, with minorities, etc.

These socially oriented regulations are common in many countries. Because enacting these regulations is politically less burdensome than enacting spending programs, they tend to be abused.

5. - Countries' Preferences

While countries have used all three of these instruments in pursuing their objectives of social protection, there is evidence that some of them have preferred one instrument over the others. For example the Nordic countries of Europe seem to have had a strong preference for public spending as the preferred instrument. As a consequence they have had the highest tax and spending levels. The Anglo-Saxon countries seem to have had a preference for tax expenditures. Thus, their average tax levels have been a smaller share of GDPs. Other countries, including France, Germany and Italy, have used all three instruments. In Italy public spending has been biased substantially toward pensions. In some ways, public pensions have crowded out other forms of social spending.

It is not obvious which of these instruments is more damaging to economic growth. Because tax levels and levels of public spending are more visible, there has been a tendency to look at the spending levels of the Nordic countries and the accompanying tax burdens as obvious obstacles to economic efficiency and growth. However, the other instruments, and especially regulations, can also put breaks on economic growth. For this reason, more recently, there has been much more attention focused on regulations especially in the three large European countries. Regulations can, at times, be even more damaging than high tax revenue especially when high tax revenue is derived from transparent, well administered, and efficient tax systems. In recent years the quality of the tax systems of the Nordic countries has improved a lot and the quality of their regulations is very high. The same cannot be said for other European countries where inefficient regulations in various sectors and especially in the labor market and inefficient tax systems continue to exist and to constrain their growth rates.

6. - Looking at the Future

What will the future bring for the systems of social protection that have existed in industrial countries and especially in European countries? There are three developments that can play a significant role. The first is demographic changes and especially the aging of the populations. The second is globalization and its impact on tax revenue and potentially on spending. The third is the growing sophistication of private markets. While the first two developments can be expected to create difficulties for policymakers, the third can help them cope with the difficulties if they are able to take advantage of that increased sophistication. These are complex issues that can only be discussed broadly here[8].

I will be brief with the first development because it is well known to economists interested in these issues and especially to those interested in pension reforms. It has received a lot of attention by international institutions, by country economists, and by demographers[9]. Under plausible forecasts for the next 50 years, demographic changes will:

(a) reduce the proportion of young people (0 to 15 years of age) in the population, due to the fall in the birth rates;

(b) substantially reduce the proportion of the population in the now legislated working age (say 15 to 64 years);

(c) sharply increase the proportion of individuals over 65 years of age;

(d) finally, lead to a remarkable increase in the proportion of the very old, those (over 80 years of age) in the population. In fact the fastest growing cohort is that of individuals over one hundred years of age.

The impact of these changes on the economy and, *under current policies*, on social spending and especially on health and pensions is easy to visualize and has been estimated in several studies. Many experts have predicted disastrous consequences for pension and health systems and some have even talked about "intergenerational

[8] For more extensive treatments, see TANZI V. (2004).
[9] See also TANZI V. (2003).

wars" when the pensions promised under current legislation will not be paid or when the younger generations will be asked to pay the higher taxes needed to finance them. While the precise quantitative dimensions of the problem are subject of debate, few experts question the conclusion that *under current policies*, public spending, especially for public health and pensions, is likely to grow to levels that would make it difficult if not impossible for the governments to finance. Financing would require exceptionally high taxes on the shrinking working populations.

The second development is, perhaps, more debatable. In several publications, over the last 10 years, I have argued that, through various channels globalization, will make it more difficult for governments to maintain the current high levels of tax revenue. See Tanzi (2002). In some of these publications I have introduced the concept of "fiscal termites". Like their biological counterparts, fiscal termites, over time, will damage the foundations of the tax systems. At least eight such termites can be identified that, through their impact, will make it progressively more difficult for governments to collect high levels of tax revenue. These "termites" are: *(a)* electronic commerce; *(b)* foreign shopping; *(c)* growing foreign activities of individuals and enterprises; *(d)* intra-company trade and transfer prices; *(e)* growing inability (or willingness) to tax financial capital; *(f)* growing importance of electronic money; *(g)* tax havens and off-shore financial centers; and *(h)* complex financial instruments and the activities of hedge funds.

These developments are likely to affect, first, the tax structures and, then, the tax levels. Recent information provided by the OECD indicates that the process of lowering average tax levels may have already started. In recent years several countries have reduced tax revenue. Policies that promote: *(a)* some tax coordination among countries; *(b)* source-based taxation; *(c)* much greater exchange of information among countries; and *(d)* the creation of an international organization to monitor tax developments, might slow down this process but it is unlikely that it can be reversed.

Thus, while demographic developments are very likely to increase pressures for some forms of public spending connected with particular aspects of social protection, the impact of globalization on tax systems is likely to make it progressively more difficult, especially for European countries, to maintain the current levels of taxation. Thus, the future is not likely to be friendly for the public finances of industrial countries and especially for European countries.

It should be added that globalization is also likely to reduce the government's ability to use tax expenditures and perhaps regulations as effective instruments of social protection. Tax expenditures will become less significant because of the reduction in tax rates. Marginal tax rates on personal incomes have already fallen substantially and they are likely to fall even more in most industrial countries thus reducing the impact of tax expenditures on particular forms of private spending that the governments want to promote. Further reduction in the rates will make this instrument less effective[10].

Globalization is also putting pressure on countries to become more efficient. This pressure will translate into the progressive liberalization of labor markets and other markets such as those for goods and services. After all the call for structural reforms means in part the elimination of many of these regulations. What has been called the New Architecture of the International Financial System has been promoting standards and codes for financial and other markets that will tend to standardize regulations thus reducing a country's ability to promote social protection through some of these regulations. There are also strong pressures on countries to reform labor and other markets.

This brief discussion has led us to conclude that:

(a) demographic developments *under current programs* will lead to explosive unfinanciable increases in public spending; while

(b) globalization, in all its manifestations, will reduce the governments' ability to raise taxes or to use tax expenditures and regulations as instruments for the promotion of social protection.

This is surely not an attractive scenario. If it were to prove

[10] Should the movement toward flat rate taxes catch on in industrial countries, tax expenditures will lose their power.

correct, it would sharply reduce the state's ability to continue to promote the objective of social protection. It is true that, as we have argued earlier, before the introduction of modern forms of social protection, there were various informal forms that to a considerable extent achieved similar (but less certain) results. The problem is that it may not be possible, or even desirable, to put the clock back. Other options must be used.

Private markets have become more efficient and in the future they can be expected to become even more efficient. Thus, they could play a larger role in providing protection against economic risks for those who will be able and willing to buy it. See Tanzi (2004). In this new world the role of the state could remain important but its character would change. The new role would consist of: *(a)* less public spending, *(b)* less reliance on «tax expenditures», and *(c)* more reliance on *particular* forms of regulations and on the market. The state should privatize a good part of its activity, taking advantage of the greater sophistication of the market and taking as one of its fundamental roles the development of markets, where they do not exist, and the improvement of existing markets. Thus, the role of well trained regulators would become very important[11].

There are no reasons why efficient private markets could not develop in the fields of pensions, education, health, provision of infrastructures and in many other areas. For example in the area of pensions a Chilean style alternative would, over the long term, reduce the government's role as a provider of pension payments. This alternative could leave to the government the responsibility of guaranteeing *minimum* pensions to all citizens who reach a given age consistent with current life expectancy. It would transfer to the private sector the task of paying higher pensions or building higher assets for individuals to be drawn upon in old age. Widespread use of school vouchers for poorer students, together with some privatization of educational services, could reduce the role of the state in education and especially in higher levels such

[11] This implies extreme care in the selection of individuals who will perform these regulatory functions.

as universities. Surely there must be development in the area of health that could restrict the government role in this area. The possibility of using health accounts as in Singapore should be explored. See Schreyögg and Kim (2004). Programs must be developed that allow the government to subsidize those who are at the bottom of the income distribution who could not afford to buy insurance against risks available from the private sector. But this is a long way from programs aimed at satisfying the needs of the whole population through public spending. For much of the population it should be more efficient to buy directly educational and health services rather than buying them through the taxes that they pay.

Concluding Remarks

In the future, programs of social protection cannot continue along lines similar to those that have prevailed in recent decades. They also cannot go back to the past when some social protection against risks with economic consequences was provided to a substantial share of the population through informal, private activities. At that time, social protection was far from being universal and the state's role was very limited. In the future universal and publicly-financed forms of social protection would give way to targeted forms aimed at those who cannot afford buying it from the market.

Economists could play a significant role in bringing about a major change in what the state does in the economy. The new role will need to be that of a provider of information; a promoter of an efficient market; and, where necessary, a regulator for mandatory programs[12]. Whether the state will be able to rise to this new role remains to be seen. If it is not able to do it, major problems will develop in the public finances and in the economies of European countries in future years.

[12] This again emphasizes the need for choosing the right candidates for the regulatory agencies. These individuals must understand the role that a well developed market can play and promote the development of such a market.

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