Economic Theory Versus Economic Reality: Dealing with Pandemics and Other Global Public Goods and Bads

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Abstract

In democratic countries with market economies, there is the presumption that elections determine policies, including tax policies, to deal with expected, collective needs and with national public goods. However, the importance of global public goods and of global public "bads" has increased in a globalized world. Policies have continued to be made by national governments. This creates problems in dealing with pandemics, global warming and other global problems, that may come at times unexpectedly. This new reality has not led to changes in either the institutional setting of policies or the preparation for "uncertain events". National policies continue to be focused on normal developments. They tend to ignore the possible coming of" uncertain events", events the probability of which cannot be estimated statistically. Dealing with uncertain, unpredictable events is of course difficult. However, these events do occasionally materialize as history shows. This points to the need to reorient both economic theory and economic institutions more towards these uncertain, and often global, events. There is a need for developing a federalism literature at the global level.

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Introduction

Taxation and public spending have been, traditionally, the major policy instruments used by governments to promote collective, nation-wide, goals. And national governments have been the institutions through which countries' citizens pursue, or should pursue, their *collective* needs. Of course, it is not easy, in practice, to determine with precision what a country's collective needs are, in general, at a given time; and especially to determine the size of the public resources necessary to finance their provision. One of the reasons is that some governments are more efficient than others in promoting their operations, and some populations are more community- oriented and more explicit on what they want than other populations. Also as Kenneth Arrow and Amartya Sen theorized many years ago, it is difficult to aggregate the preferences of different individuals. At some times there may be specific collective needs that are strongly felt. Good health is clearly one of them, especially during pandemics.

In *democratic* countries, that operate with *market* economies, the usual assumption has been that requests for general, collective needs are determined through the democratic process, generally through elections. That determination will suggest a desirable level of taxation and of public spending. Therefore, at least in theory, free elections, should be able to indicate to the governments the resources needed and also how the public spending should be allocated among the country's citizens and needs.

In the real world, there will always be some individuals, or some groups, who will think that, whatever the tax level is, it is too high; and others who think that it is too low. Still others may think that the taxes and the spending are not being used fairly. Given the collective needs, the more efficient is the public sector in its operations, the less taxes and other policies a country will require, to satisfy its collective needs.

There are, today, some vocal economists, and also some politicians, who recommend the use of more public borrowing, rather than taxes, to finance public spending . This relatively recent view argues that the use of public debt will leads to more economic activity and employment, without creating negative and significant, long run consequences, as major economists of the past (David Hume, Adam Smith and others) traditionally had assumed that it would. Many present economists continue to share that traditional view.

The public finance theory has assumed that the needs and the resources to satisfy them are strictly those of the *nation and of its country's citizens* . Foreigners are not part of the determination of the collective goods needed, and only the interests of the countries' citizens count. Public finance theorizing has, traditionally, been organized along *national* lines. See, for example, Musgrave, 1959, or Rosen, many editions. However see also Musgrave and Musgrave, 2003, for a later view. If there had been some debate, it has been related to the extent *sub-national* government within countries should play a role, in reflecting collective national needs, because within a country the interests of different regions may diverge. This gave rise to the enormous and growing literature on fiscal federalism. However, the needs of the citizens of other countries were still assumed not to count. *There has been no fiscal federalism at the global level.*

With the passing of time: (a) many activities have become less localized, more globalized, and more globally interconnected than in the past ; (b) some needs and their provision have become multinational, or even global; and (c) some public goods and public "bads", that had traditionally been strictly *national,* have acquired global characteristics. The result is that what now happens in the rest of the world counts much more for what happens to specific countries, than it did in the past.

Just think of pandemic and global warming, and their global and country-specific impact. This means that the traditional concept of collective interest, as being strictly the summation of the exclusive interests of a countries' citizens, has become increasingly anachronistic, especially in some circumstances, which have become increasingly more frequent, including pandemics. There are, now, some public goods and public "bads" that have acquired clearly multi-national or global dimensions, and that cannot, any longer, be dealt with, with strictly national policies. Musgrave and Musgrave, 2003. This means that the traditional theory of public finance, and to some aspect that of competitive markets must be adjusted to the new reality. It must acquire a more global dimension, as some writing over past years had argued . See Tanzi, 1995, 1998, 2003; 2006; Kaul et al. 2003, Kaul and Conceicao, 2006, and the recent article by Bucholtz and Sandler, 2021.

Events such as pandemics, climate change, cross-countries migration, money laundering and tax evasion, cybercrimes and other multi-country crimes, over-fishing of the oceans, and others, have become too important "public bads" to be ignored. They must become integral parts of current economic and public finance theory, but are not. The rise in the importance of global events have made evident the need for significant changes in scope for economic theory. However, much theorizing has remained strictly national and has not expanded to incorporate these global events and developments.

Of related interest is that the world political or institutional architecture has also not changed, to incorporate this new reality. Most *enforceable* economic decisions have remained strictly national, creating some difficulties that have become increasingly evident in the current pandemic and also in relation to what to do about global warming. From these events it has become clear that strictly national policies are not sufficient or effective to deal with them. These national policies cannot be optimal.

Over the last century, views about taxation and public spending changed significantly in some ways. Also views changed about what the desirable government role within *national* economies, should be. Broadly speaking and recognizing the existence of strong opposition that has continued to come from libertarian and conservative individuals and groups, the desirable government role, still *within a country,* came to include (a) the need to *redistribute* some income and wealth from richer to poorer citizens, when the distribution generated by the market and by the existing national rules, was considered too uneven, and (b) attempts by national governments to promote, with their policies, full, or fuller, employment of labor and capital in the country, especially during business cycles.

These changes were still limited to single countries. They were not extended to the larger world. The policies remained *national*, and the main goal remained that of increasing the welfare o*f the citizens of a country*. The rest of the world continued to be largely ignored by the theory (though increasingly less by the practice). The implicit assumption remained that the rest of the world did not exist or, if it did, it did not matter much.

An additional characteristic and perhaps shortcoming of the traditional theorizing was that, the policies that were considered desirable were not only *domestically oriented* but were also policies good for *normal* times. The desired policies were focused on immediate needs. They largely ignored potential, *future events that were still uncertain*, events, the probability of which could not be statistically determined at a given time, even though they had some realistic possibility of happening at some unspecified but not at a far too distant future time.

Random disasters and other possible, bad events , such as the coming of pandemics, famines and others, have continued to be ignored by the current theorizing and by the policies, even though such events had been experienced in the past, and were likely to be experienced again in the future within the lifespan of many citizens.

Wars did, occasionally, create *exceptional* circumstance for countries. During wars, the tax levels of the warring countries were pushed up, to finance the military spending, and to avoid the creation of high public debt. In peaceful times the tax level and the tax structures were expected to be returned to normal levels, and to be consistent with the needs of the national economy *in normal times.* National policies were biased toward winning the next elections. The taxes used were expected to be *efficient* and *sufficient* to satisfy the *routine and immediate* needs of the *national* citizens.

The above have been, in essence, the guiding theoretical principles of market economies, in countries that are democratic, even though the practice may nor have always followed the theory. The principles have largely continued to ignore *global* developments, except for their direct impact on the national economy. Given those principles governments have been expected to keep the tax levels as low as possible and the regulations limited, and to focus public spending toward satisfying the immediate, short run, needs of the country's citizens.

Future but *uncertain* events, as compared with *risky* ones, have not attracted as much attention in the theory as they should have. A government that would spend much money to be better prepared *for needs that might be created by events that are uncertain and future,* or for needs that were seen to be global, rather than strictly national, such as those imposed by possible future pandemics and climate change, would likely pay some political price in the elections.

Consider now the behavior of private enterprises operating in competitive markets. They must minimize the cost of labor and capital, and must keep inventories low, in order to remain competitive. They cannot give much thoughts, or pay much attention, to events that are *future* and *uncertain*, such as pandemics and major natural disasters that might never materialize. Some of these events might have a global character. The enterprises would continue to focus on the short run and on normal developments to continue to be competitive, See Tanzi, 2021.

2. Dealing with the Unpredictable

Normally future difficulties that may be created by major catastrophes, including pandemics, have been considered "Acts of God". The possibility of their coming is often ignored. These possible, future crises have the characteristic of being impossible to predict statistically, with respect to both their t*iming* and their *severity*. This makes them different from risky events, which are statistically predictable. Because of this, they often do not make governments and private enterprises change their normal behavior, until the events actually happen. The *timing* of pandemics and of major hurricanes and earthquakes, cannot be predicted. Neither can their *severity.* Unfortunately, major disasters are and have been a fact of life and the fact that they cannot be anticipated statistically does not mean that they will never materialize. It also does not imply that some planning could not be made for their eventual coming.

Over historical times there have been several, major pandemics, including truly major ones, such as the Black Plague of 1346-52 in Europe, that killed at least a third of the European population, and the Spanish Flu of 1918-1919, that killed more people than had died during the First World War. There have been other major natural disasters (hurricanes, floods, earthquakes, volcanic eruption and others) that have caused many deaths and major disruptions. . See Tanzi, forthcoming.

Some of these disasters happened in the distant past, at times when the role of governments and their capacity to act were very limited. When the disasters actually came, few citizens could have expected the governments to be able to do much. Now governments have much more capacity to act, and they may also have more information and better tools to predict. Wars had been in a different category. They could not be considered "Acts of God", and, to some extent, they could be anticipated.

In recent decades, *business cycles,* which included the Great Depression of the 1930s and the Great Recession of 2008-9, attracted the attention of economists and governments, They also led to expectations that some policies could be adopted to fight them, when they came, and even, in anticipation of their coming, in order to reduce their intensity and their impact. This led to the Keynesian Revolution, which called on governments to increase spending during recessions, and to finance the higher spending with fiscal deficits. It also called for permanently- higher public spending, and for the use of *built-in stabilizers*, to automatically reduce the severity of recessions.

Countercyclical fiscal policy may have been the first call on governments to deal, *on a permanent basis,* with *economic* crises, crises that seemed to arrive with more regularity than *natural* ones. See Solimano, 2020. However, the policy call was still for the individual response by single countries, it was not for coordinated actions by several countries. However, increasingly there have been calls, at the political and also at the professional levels, to have globally coordinated responses by country groups, by the G20, the European Union, and others, and also some professional discussions of these possibilities. See Tanzi, 1996.

There were *no* similar calls to prepare for and to deal with eventual, natural catastrophes including pandemics. The randomness of the latter, in both time and severity, discouraged these calls. The way economies and governments operate, in democratic, market economies, does not encourage governments and private enterprises to adopt policies or to take actions, in normal times, that would make it easier for them to deal with the catastrophes, when they eventually came. See Tanzi, 2020. This preparation might involve more spending, by governments for infrastructures or for hospital beds, more regulations to make buildings safer against floods and earthquakes, policies to make energy greener, more retention of profits, as precautionary balances, by private enterprises and others. It would also require some formal classification of future uncertain events, to see whether some are more likely to occur than others, even though they still remain "uncertain " in the Frank Knight definition, and have not become traditional, measurable risks. Knight, 1921.

There would be costs and some difficulties with these policies. For governments, there would not be much political advantages, and only political costs in spending money, because the benefits, if any, would be seen later, and, at times, much later, while the costs in higher taxes, or in more strict regulations, would be felt immediately, by the citizens.

The frequency of political elections, (that makes the relevant time horizon of governments short), and the political pressures to keep public spending and tax levels low, would often discourage *democratic* governments from allocating significant resources to provide better protection against the future, uncertain events. A government that invested large resources in trying to protect a country's citizens against such events, would be criticized for wasting taxpayers' money. Uncertainty would play against future security.

To some extent governments have relied on regulations, more than on spending, to promote better safety against some such events. For example, in areas subject to earthquakes, such as California or Japan, they have strengthened building codes which, by increasing the cost of housing, have at times led to criticism.

On the side of the private sector, the forces of competitions promote actions or behavior that do not help in dealing with uncertain, catastrophic events or even with recessions, that may affect them more directly. Private enterprises, operating in competitive markets, face strong incentives to keep their costs low. They do so by squeezing their real wages, minimizing their work forces, and keeping inventories down.

The CEOs of corporations have incentives to distribute the corporate profits to their shareholders; or to use the profits to buy the shares of their own corporations. These actions help keep shareholders happy and to justify the CEOs' high compensation packages. They also reduce the taxes that the owners of the corporations pay on their corporate earnings, because of the non taxation of unrealized capital gains, and the often lower tax rates on realized gains .

Corporations are also encouraged to make greater use of debt, to finance their investments, or even to buy their own shares, The deductibility of the interest paid on the debt, in the calculation of taxable profits, makes this policy attractive. When the cost of borrowing is kept low by central banks' policies, as it has been kept in recent years, these incentives are also stimulated, leading to high shares of private debt and to lower tax revenue.

These and other actions contribute to conditions that make corporations more vulnerable to crises, when the crises come. If the corporations are "too big to fail" they can hope that the government will come to their rescue in case of crisis, as happened to some of them during the Great Recession of 2009-10. The workers are the ones who often bear the major costs, because they lose their jobs, their incomes and, in countries such as the USA, even their (employment-linked) health insurances.

The above observations move the focus from what governments and enterprises should have done, but did not do, in anticipation of random but possible dangerous events, including pandemics and, increasingly, climate change, to what they should do, when they are faced by events such as pandemics and others that may become more frequent in future years. This question is addressed in the following two sections, with special reference to the current pandemic and to global warming..

A first obvious observation concerning governments is that, when major disasters are realistic future possibilities, even though their probability distribution cannot be measured statistically, as it can for normal risky events, it would always be wise for governments to keep some space in their fiscal accounts, so that it would be easier for them to step in with additional spending, when the time to do so comes. A government that is already burdened by high debt, and is already relying on high and bad taxes, will have less degrees of freedom to act, than one that has a low debt and more fiscal space. *Initial fiscal conditions* do matter and remain important.

The above conclusion might be questioned by those economists who have complained about what they have called "austerity policies", policies presumably followed by governments and considered too "austere", even when the public spending, the public debts, and the fiscal deficits had been already high. It is also an argument against those who believe that there is almost no limit to what governments can borrow, as long as the borrowing is in the country's own currency. The reason given is that the growth rate of the economy is likely to exceed, in the future, the cost of borrowing. Some believe also that Inflation is no longer a present or future problem, regardless of the level of public debt.

Similar observations can be made concerning the behavior of private enterprises. In this context the behavior of American and Japanese enterprises may be of some interest. In good times, Japanese enterprises tend to retain larger shares of their current profits. They use them to retain their work force during less favorable times. American companies do not. In bad times the latter lay off their workers. The consequence is that unemployment fluctuates less in Japan than in the USA.

Most workers depend on their wages for their purchasing power. When they lose their jobs, they remain without income. On the other hand, shareholders of corporations normally have some or much accumulated wealth to fall on. They allocate their total wealth on the shares of different corporations. Thus they "spread their eggs in many baskets". The poor performance of a single or of some enterprises does not affect the total purchasing power of rich shareholders as much as the loss of their jobs does that of workers. Furthermore, generally, the tax treatment of capital income tends to be lighter than that of wage income.

3. Taxation in Times of Pandemics

Let us now come more directly to the use of taxes in time of crisis, starting with some observations that are largely based on the US experience. During the ongoing Covid 19 pandemic, employment collapsed and millions of workers lost their jobs, because both the demand for and the supply of many goods and services was reduced by the pandemic. Many of the workers who lost their jobs did not have money saved on which they could depend. Unemployment claims rose sharply and have remained high in many countries. In spite of recent improvements, and optimistic official forecasts, the long- run, future impact of the pandemic on the world economy remains uncertain. The situation has improved in some countries and has worsened in others. Consumer confidence has continued to be low, global trade has been negatively affected, and public debts have soared and are continuing to grow, raising concerns about the future fiscal sustainability of various countries. Some activities have been affected more than others.

The remarkable thing about the present situation is that the stock market, in the USA and in other countries, has been doing very well, in spite of the pandemic. The current level of the US stock market is at a historical high, making many rich individuals even richer. This disconnect between what has been happening to the real economy and to many workers, especially to workers in so called "essential occupations", and to the well to do, is strange and somewhat worrisome. Million dollars compensations have continued to be paid to the CEOs of corporations, even in some enterprises that have lost money.

The reasons for the disconnect may be largely two: first, the changes in tax policy that had taken place in recent decades, and, second, the monetary policies that have been followed in recent years. Over recent decades, the share of total income and wealth received or owned by a small minority of the population (1.0 or the 0.1 percent) increased remarkably and was taxed at lower rates. This minority has been the beneficiary from the past economic growth. These are largely the same individuals who have continued to benefit from the current stock market boom. This may have been Pareto Optimal, if the remaining 99 percent of the population did not experience an absolute fall in income, but it could not have been considered desirable, from a distributional or utilitarian point of view,

In spite of the popular belief, commonly held, about the benefits of using crises to make major policy changes , major crises may not be the best of times to make these changes. During crises, it may generally be better to focus on the immediate needs of the majority of the citizens, and to leave more fundamental and permanent reforms to better and normal times. During major crises, such as pandemics or major recessions, the important, immediate need to satisfy should be that of protecting the standards of living of individuals who have lost their jobs, and who did not have saved assets to sustain them. These should be the individuals to be helped by government's assistance.

The assistance could be financed partly by public debt and partly by increasing taxes on those best able to pay them. These additional revenues could come from taxes on high incomes, on high wealth, or from "Tobin taxes", taxes on the exchange of shares in the market, in countries that have well developed stock markets. These special taxes, imposed to assist those in difficulties, because of the pandemic or the recessions, would be *temporary* ones. They would last for the period of the pandemic or the crisis. They would make the individuals with high income and high wealth share in some of the costs of the pandemics giving more legitimacy to the existing economic system.

Central banks should pay attention to the distributional, or equity, aspects of their monetary policies. They have paid little or no attention to those aspects, assuming that distributional aspects are not part of their mandate, or that, by promoting economic activity with low rates, they were helping everyone, which was not often the case. Over the years, monetary policy has become progressively less distinguishable from fiscal policies, in their real and distributional effects. Like fiscal policies, they have been importantly affecting the income distribution, and not in a desirable direction..

4. Economic Theory and the Globalization of Public Goods

Economic theory and economic policy have continued to assume that economic needs are essentially *national*, whether they are individual or collective. The national governments are expected to deal with those needs at the *national* level. However, in a world that has become increasingly interconnected, many needs have acquired global dimensions. To deal with them has increasingly required global responses. Economic theory and policies have not yet fully caught up to this important change.

Take for example the experience with the Covid 19 pandemic. This has been a truly global pandemic, one that has affected all countries. The virus has not respected national borders and the fight against it should have been a global fight, but it has not been. The actions by individual countries, such as the use of vaccination and masks, have helped the population of the particular countries that have used them. However, as long as the pandemic continues to exist in other countries (India, Brazil, Mexico, Peru, etc.) the problem remains a problem for all countries. No country will be completely safe until all countries are safe, and global actions, such as the sharing of vaccines should have been taken.

The same is the case with man-created global warming that, in different ways and to a different extent, is affecting the whole world. The actions of single countries, especially large ones, such as China, India and the USA, can help to slow it down, but, to eliminate the danger, most countries must collaborate and act together. There should not be scope for "free riders". There are many other public goods, or public "bads" beside pandemics and global warming, that share similar characteristics. The reality is that many problems and solutions to them have become global, while the power to act has remained at the national governments' level.

The institutional, political architecture of the world has remained national, and has become increasingly anachronistic. It is an architecture still based on the institutions of many (at least 200) national governments. That architecture often encourages free riding, and actions by national governments that are often contrary to what is needed as the global public interests, or, if they are, are far from sufficient.

It may be time to realize that the world increasingly needs some truly global architecture, one that in an ideal world could be provided by a world government. This however is an unlikely prospect any time soon, as powerful national governments would oppose its creation.

More realistic alternatives should be suggested by clever political scientists and economists. One possible option could be to create more powerful international institutions that would act as proxies for a non -existing world government. This had been the dream of some thinkers (Einstein, Gandhi, Churchill and others after World War Two), with the creation of the UN, the Bretton Woods Institutions, and many others.

Unfortunately, the power of these institutions, including the UN, instead of growing, has been diluted over the years. Without a truly global architecture, the world risks facing increasingly dangerous events, without clear solutions. Global warming is clearly one of them. See Tanzi, forthcoming. We need to create a field that, like fiscal federalism at the national level. would deal with federalism at the global level.

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