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Book Review

Public Finance and Public Policy in the New Century, edited by Sijbren Cnossen and Hans-Werner Sinn.

Reviewer: James Barrese

Public Finance and Public Policy in the New Century is a tribute to honor the 90th birthday of Richard Musgrave. The book evolved from a series of presentations at a 2001 conference of the Center for Economic Studies of the Ludwig-Maximilians-Universitat in Munich.

Until the 1980s, every student of public finance studied from Musgrave's *Theory of Public Finance* and the collection of public finance specialists contributing to this volume of essays is a who's who of academic leaders in the field of public finance over the past decades.[1] Musgrave provided a moral view of government that attempts to maximize societal welfare through its influences on the allocation and distribution of resources, and the stabilization of economic activity. The use of government tax and expenditure policies is now viewed as relatively clumsy short-run stabilization tools but the role of government in the maximization of societal welfare is a theme of the book and reflects the essence of Musgrave's writings, especially the purpose of the conceptual separation of the allocative and distributive functions. "In ideal circumstances, the Allocative Branch should be concerned with taking the economy to the society's utility possibilities frontier by exploiting all gains from trade, while the redistributive branch alone need be concerned with choosing the ethically preferred point (Boadway et al., p. 333)."

Because the focus of interest for this journal is risk management and insurance, most risk specialists will find section III of the book closest to their interests. The section, titled "The Welfare State in an Integrating World" contains two chapters on social insurance and one on the use of medical care by the self-employed. Other risk and insurance topics are sprinkled through the book. For example, a chapter on fiscal federalism and intergovernmental risk sharing provides a discussion of moral hazard issues in a scheme to allocate tax revenue and auditing intensity among the layers of government.

The focus of section III is the fiscal pressure of aging populations on government social insurance and medical programs. Hans-Werner Sinn begins the social insurance

[1] Musgrave, R. A. 1959. *The Theory of Public Finance: A study in political economy*. New York: McGraw-Hill. This was succeeded in the 1980s by Atkinson, A., and J. Stiglitz, 1980. *Lectures in Public Finance*. New York: McGraw-Hill.

discussion with a focus on Germany's pension insurance system. Drawing an analogy to the ability of Roman slaves to save during their captivity to purchase their freedom Prince Otto von Bismark proposed the 1881 social insurance legislation that would eliminate the need for the elderly to beg for support from their children. Like many countries, the German demographic changes since Bismark's time have moved from a situation where four workers support an elderly population to a projected 2030 world where two workers will support one retiree. The relative decline in young and the increasing longevity of the population is a problem faced by many industrial countries and Germany's reaction is relevant to the current U.S. debate. In 1992, the Bundestag defined a comprehensive program of sacrifices. It replaced tying pension benefits to gross wages with a tie to net wages; it eliminated early retirement; it abolished pensions for occupational invalidity (due to a decline in earning capacity); it reduced the benefit from 70 percent of gross to 64 percent of net wages over a phase-in period that extends to 2030 (a provision that was later abolished by a new Bundestag majority), and a host of other changes. Ultimately, Sinn recommends an obligatory private savings with a variable rate set to stabilize the sum of this rate and the country's pay-as-you-go contribution rate. Largely agreeing with Sinn's analysis, the comments by Georges de Menil ask questions that are often avoided in the current U.S. debate. He believes the only way to protect the credibility of the existing PAYGO system is to scale back entitlements but his discussion provokes questions that demonstrate the commingling reality of the taxation and allocation functions of government. Is a reduction in anticipated benefits without a reduction in contributions a tax? When is a contribution increase a tax?

Peter Sorensen extends the discussion of individual savings accounts and social insurance. He observes that the issues of moving from an unfunded to a funded pension system is analytically distinct from that of moving from defined benefit to defined contribution but that most proposals contain movements in both areas and have consequences for the efficiency of the labor markets. Sorensen's study of social transfers in Denmark suggests that the transfers and taxes smoothen the individual's disposable income over life rather than redistribute income across individuals. The introduction of individual accounts, in this case, may improve labor market efficiency and provide a Pareto improvement for people of working age. He confirms this theoretical expectation of the incentive and welfare effects of individual accounts (IA) with an overlapping generations model. Noting that the discussion is preliminary, Sorensen suggests the need for more careful modeling of the labor market effects of IAs by allowing for uncertainty and by endogenizing educational choice. He also suggests a need for distributional analysis of the effects of IAs—preferably using a microsimulation model accounting for the heterogeneity of the working population and incorporating empirically based estimates of behavioral responses.

Robin Boadway et al, investigate the use of social insurance as a tool of income redistribution. They summarize the literature addressing the reasons for public intervention in the field of insurance: transactions costs, market failures, and redistribution. In the health-care sector, private insurance has higher transaction costs than social insurance, primarily caused by relatively high administrative costs. Market failures arise because of asymmetric information between insurers and insured (adverse selection and moral hazard) and between health-care providers and health-care consumers. Finally, the redistributive argument is based on the information that risks are negatively related to income so that the poor face higher risks on average. They note that the redistribution argument is developed in a setting where *ex ante* and *ex post* moral hazards are assumed away. When either assumption is relaxed, the strength of the argument for redistribution through social insurance is reduced.

A social policy concern in the United States is the relatively low rate of health-care coverage among the self-employed relative to wage earners. Craig Perry and Harvey Rosen question the strength of the link between insurance and health-care service usage. Using data from the 1996 Medical Expenditure Panel Survey, they find that for a number of medical-care services the self-employed have the same rates of utilization as wage earners, despite the fact that they are substantially less likely to be insured. Despite their claim (p. 389) that the results are robust, Gebhard Flaig questions the robustness of the Perry and Rosen study.

Other sections of the book focus on public activities with a moral view of government that is consistent with Musgrave's outlook. Assar Lindbeck suggests that the demographically changing family structure enhances the need for a Welfare State but in comments on the chapter the book's 90-year-old laureate questions Lindbeck's optimism. Musgrave argues that an increasingly global world reduces margins and weakens the ability of particular governments to sustain a welfare state. Setting aside the issue of the growth prospects for the Welfare State, Joel Slemrod extends the discussion of the ability to finance such a state. Cross-country variations in tax compliance, the largest source of governmental revenues, are show to vary positively with the degree to which the residents of a country have trust in their government. Slemrod does not consider the possibility that tax cheating is accounted for by differences in social norms of a country, rather than attitudes of trust toward the government, a criticism raised by Micahel Burda.

Perhaps the most humorous exchange is between David Bradford and Henry Aaron. Bradford and, separately, Aaron look to a time when government accounting will better permit evaluation of public policy in terms of Musgrave's innovative allocation, distribution, and stabilization functions of government. Bradford suggests that simple models can help but Aaron criticizes this approach as a way to introduce new problems into "budget categories in the United States and elsewhere (*that*) contains conventions that make no economic sense" (p. 117). In a self-deprecating aside, Aaron provides comments reflecting the never-ending conflict between practical solutions and theoretical possibilities. "How could one correct these problems? The answer, I think, is . . . to have a fully articulated and completely reliable general equilibrium model, all of whose parameters are generally accepted, that shows the effects of each individual's (family's) and each business's real, infinite-horizon net worth (p. 119)." Perhaps this can be instituted in next year's budgetary process?

The 2003 collection has already made its way onto the syllabi of graduate public finance courses around the world as an update of the primary literature. The presentation is cohesive and many of the points raised in the discussion of social insurance have relevance to the current debate in the United States. For this reader, a shortcoming of the book, given its title in public finance and public policy, is the relatively heavy focus on taxation. The public policy coverage of expenditure, externalities, and the macroeconomic functions of government are only lightly touched upon and then, often, within the confines of a tax application.