1-1-2012

Book Review: Modeling the Composition of Government Expenditure

Cameron A. Shelton
Claremont McKenna College

Buchbesprechungen / Book Reviews

Review of "The EEAG Report on the European Economy". EEAG European Economic Advisory Group at CESifo. Munich (CESifo Group) 2010, pp. 90, € 60,– (subscription rate), ISSN 1865-4568.

Writing a book on ongoing topics is a great challenge. There is the constant risk that reality will outdate the analysis. The authors of this book have done an excellent job handling this risk. As their contributions on selected current economic problems in Europe are profound, the recent small shifts in policy debates do not affect their analysis. The authors form the European Economic Advisory Group (EEAG) at CESifo, which has been publishing an annual report on the European Economy since 2002. This book is structured into policy recommendations, a summary and six chapters.

The first chapter offers a macroeconomic outlook for the world economy. Assuming that the European debt crisis can be kept under control, the authors expect a slow down of real growth to an increase of world GDP of 2.5 per cent for 2012. However, this growth rate is driven by the newly industrialised countries with an expected growth rate of 5.6 per cent compared to 1.2 per cent in the industrialised countries – including the Euro area with an expected negative growth rate of -0.2 per cent. Yet, the development within the Euro area differs widely. Whereas the European integration process helped the poorer regions to catch up with the richer ones until roughly 2005, this convergence process is reversed now, thus making an internal or external realignment of prices in most of the so-called periphery-countries necessary.

This aspect is thoroughly discussed in the second chapter where the European balance-of-payment problem is extensively analysed. The authors provide two main proposals to overcome the European debt crisis: first, the introduction of so-called 'euro-standard bills' and, second, the settlement of target balances. 'Euro-standard-bills' are short-term treasury bills issued by each national government according to a harmonized European standard, subject to joint supervision. These bills would be collateralised with preferential claims for future tax revenue or public real estate. However, there would be no joint liability but each nation state would be solely responsible to serve these bills. Over a certain period of time these bills could redeem the intra-Euro target debts, thereby, reducing target imbalances within the Euro area.

The third chapter shows how and why banking regulations failed during the global financial crisis of 2007/2008 and provides recommendations how to prevent future failures. Reforms have to be based on some basic principles. The most important include, first, strengthening the European Central Bank; giving it a true mandate to maintain financial stability. Second, loopholes have to be closed, i. e., regulation must cover all entities carrying out banking activities. Third, so-called system-relevant banks have to internalize external effects of their potential bankruptcy either by means of a Pigouvian tax related to the respective systematic risk or by higher equity requirements. And fourth, there cannot be a fragmented approach to financial regulation, i. e., links between liquidity, capital and market liberalisation must be considered.

The following two chapters provide detailed and interesting case studies on how Sweden and Hungary handled the economic crisis. In the early 90s, Sweden suffered a deep economic crisis in conjunction with high public deficits. To overcome this crisis, new stronger budgetary procedures were introduced, while both expenditure and debt targets were defined. Furthermore, sophisticated systems to monitor public finances had been installed. In contrast to the developments in Germany and Europe, these strict fiscal rules were respected. Consequently, Sweden has performed extremely well during the current economic crisis. A high degree of fiscal transparency seems to be more successful in achieving fiscal discipline than binding rules with strong enforcement mechanisms – as planned in the European Fiscal Compact. The authors add that high output growth eased the fiscal consolidation process.

Hungary faced an opposite as it changed from a reform-oriented nation to one of the financially weakest countries in Eastern Europe. Hungary started liberalising its economy in the 1980s and was, therefore, well prepared to converge quickly with the European Union in terms of income levels. Since 2005, however, the convergence process has stopped for various reasons. First, Hungary has run excess deficits since joining the European Union. Second, there are persistent fiscal election cycles. And third, external debt heavily increased prior to 2008 due to very risky investment policies of Hungarian banks. Hungary twice requested IMF support: in 2008 and in 2011. The government tried to fight these developments by establishing an independent staffed fiscal council to monitor fiscal performance. However, the council was completely dissolved after it criticised the government's budget proposal. Along with poor fiscal performance, there were fundamental structural problems resulting in slow economic growth, low investments and low labour force participation.

The last chapter of the book illustrates the problems of effectively internalising external effects from CO2-emmissions and criticizes the existing ways to do so. The authors stress that reducing fossil fuel unilaterally in the European Union might not lower global emissions due to the leakage effect. However, little is known about this effect. If is does not exist, the authors claim that a proper CO2-trading-system could efficiently reduce CO2-emissions. Most importantly, policies have to be based on the *one price principle*. The costs of reducing CO2-emissions by one unit must be the same, no matter where and how it is done. The current policies in the EU member states are not consistent with this principle. Introducing an EU wide CO2-tax would be a first step toward harmonizing EU policies and achieving the *one price principle*.

In chapter 2, the authors briefly discuss the potential lack of political support for true fiscal integration in the European Union in the foreseeable future. Thus, the reader may want to learn more on political economy aspects. How could the majority of Euro area member states be convinced to agree to the above mentioned proposals? Even if governments of countries under extreme financial market pressure agreed to unilaterally bear most economic and fiscal costs, the problem of missing binding contracts remains. Looking at recent developments in France and Greece, it is obvious that the traditional saying *pacta sunt servanda* does not necessarily hold for the European debt crisis. After elections, France's new president immediately questioned to a large extent the fixed European Fiscal Compact; and developments in Greece also do not suggest that commitments are always stable and long lasting.

The third chapter thoroughly analyses shortcomings in financial market regulation. However, the authors remain silent on the situation in the US and US-EU relations in this aspect. It might be interesting for the reader to gather some insights into international aspects of banking regulations, too. Emphasizing the importance of fiscal transparency and of potential politician's supervision by the electorate in chapter 4 is a very important aspect that is neglected in many other analyses on fiscal discipline. It is a great achievement of this book that this aspect is strongly high lightened. It could be also decisive for the success of the German debt brake and the European Fiscal Compact.

This book offers a wealth of thoughts, insights and potential solutions to the on-going economic problems within Europe. Economists of various institutions interested in macroeconomics, public finances and banking will benefit from this book. I particularly appreciate the clear and precise policy recommendations. It is not only interesting reading them, but these recommendations distinguish this book from the others that also analyse the European Economy. One of the greatest merits of this volume is that the authors not only analyse the situation, but also dare to draw strong policy conclusions and derive policy recommendations.

Berlin School of Economics and Law, DIW Berlin — Beate Jochimsen

Creedy, John, Solmaz Moslehi, Modeling the Composition of Government Expenditure. Cheltenham (Edward Elgar) 2011, pp. 256, 69.95 Pound (Listenpreis), ISBN 978-0-85793-673-8.

Throughout the developed world, public finances dominate headlines. Given the widespread unsustainability of budget plans and the bitter attrition of retrenchment, they are like to do so for the next decade or more. As they have long done, different polities are likely to make different choices for how to spend dwindling public moneys. Understanding the sources of past heterogeneity – why countries have differed in their public spending – is thus of interest as we enter an age of fiscal adjustment. Messieurs Creedy and Moslehi offer us a technical primer laying the groundwork for modeling efforts.

The authors' baseline approach takes the tax rate (and thus the size of government) as given and looks at the subsequent choice of composition between a universal flat transfer payment enabling private consumption and a non-excludable public good. This choice is modeled first as the result of a voting equilibrium and second as the optimal choice by a benevolent social planner.

Not surprisingly, the composition depends on the ratio of the median to the mean income. This is analogous to the Meltzer-Richard result for the size of government and springs from the same choice of direct voting as the mechanism for social choice. Better yet, the authors show that the social planner's optimal allocation depends – with a few simplifying assumptions – on a similar ratio of a welfare-weighted mean income to the arithmetic mean income. The welfare weights are derived directly from the social utility function. Thus one can see the general result that the social choice mechanism determines the weighted-income measure that drives the composition of spending.

The authors are primarily interested in the effect of pre-tax income inequality on this composition. The basic result is that higher inequality leads to more transfers and fewer public goods. Both of these goods are enjoyed equally by all in the population. So why does the composition vary? The intuition: voters have a Cobb-Douglas utility function in private consumption and public goods. For a fixed mean income and tax rate, changing the composition of government spending involves a tradeoff between private consumption (partially financed by transfers) and public goods. Thus, as the median voter gets poorer, and her income affords fewer private goods, she wishes to rebalance between public goods and private consumption by pushing the composition of government spending toward transfers.

The organization of the book is standard for an exploration of models: the first few chapters provide the basic framework and the core result. Subsequent chapters explore various extensions such as endogenous work effort, home production, public education, OLG, and endogenous factor prices. The authors show that the basic result applies in a wide variety of contexts. Adding home production slows the move from public goods to transfers because transfers create a disincentive to work but does not reverse the result. Ditto for endogenizing labor supply. Adding preferences over inequality, moving to an OLG where transfers are a PAYGO pension, and adding education – a public good that improves labor productivity – are all explored without changing this central comparative static.

After producing and signing the comparative statics, the authors quite helpfully run calibration exercises to give a rough sense of the magnitudes involved. I found this quite useful for understanding both the shape and strength of the partial effects. For instance, the calibrations show that the relationship between inequality and the ratio of transfers to public goods is pretty flat over the relevant range, possibly explaining the inability of prior empirical studies to find significant results. Calibrations also show that the effect of the tax rate on the ratio of transfers to public goods, while concave, is monotonic within the relevant range. These calibration exercises are produced consistently for the various modeling extensions and provide food for thought for both modeling and empirical work.

The authors also use their calibrations to back out implied values for parameters in a national (citizen or social planner) utility function. They can thus claim to show that Germans have the highest inequality aversion or Americans have the highest preference for public goods (relative to transfers). I find this exercise less useful because at heart I disagree with the interpretation. In my opinion, these implied parameters are really more like a residual containing all the many sources of un-modeled heterogeneity as well as the cultural variation on which the authors choose to focus. Interpreting as (cultural) preferences ignores the supply-side: the relative cost of public goods and, more importantly, cross-country variation in political institutions. It also ignores non-cultural aspects of preference such as demographics. There is a good deal of prior work – both theoretical and empirical – suggesting these factors are relevant to explaining crosscountry heterogeneity. Finally, ignoring the simultaneous differences in the size of government further complicates the interpretation. For example, the idea that Scandinavian countries attach the lowest preference for public goods is hard to accept because it ignores the division between private goods and government provision ensconced in the tax rate. A better description might be that these countries have similar preference weights on public goods but higher weights on transfers relative to private consumption.

The quality of explanation is uneven. Sometimes the approach and intuition are well explained, at other times even the interested reader must puzzle a while to decide what is being done and what is learned, and at other times there is unnecessary repetition. In short, it reads a little like a set of papers stitched together. But while the writing is not a source of pleasure, neither is it a serious hindrance. Most importantly, the book gives consistently thorough explanation of the technical details: the non-specialist economist can, without much effort, follow sufficiently to reproduce in full on his or her own.

There are a few nice modeling tricks that are used repeatedly and would be helpful to others seeking to work in this area. For example, the authors repeatedly remind the reader of Roberts' (1977) result of "hierarchical adherence" as a relaxed version of the singlepeaked condition of Downs. This is a rather useful result that is not often remembered and utilized. The authors also offer a detailed explanation of how to simplify the social planner's optimum to a form that is easily comparable to the voting equilibrium.

By no means do the authors exhaust the set of interesting theoretical analyses; myriad important extensions come to mind while reading of which non-homothetic preferences, representative government, and voter turnout are the most important. But the very instigation of such brainstorms shows this book provides very useful groundwork for modeling the composition of government spending. Scholars with a desire to explore and explain the future of public finances will find this a helpful launching pad.

Claremont McKenna College, Claremont, CA　　　Cameron A. Shelton

Hagemann, Harald (Hrsg.), Wissen / The Knowledge Economy. Studien zur Entwicklung der ökonomischen Theorie XXVI. Schriften des Vereins für Socialpolitik Band 115/XXVI. Berlin (Duncker & Humblot) 2011, 274 Seiten, € 74,–, ISBN 978-3-428-13582-0.

Der vorliegende Band enthält acht überarbeitete Referate der Jahrestagung des Dogmenhistorischen Ausschusses in Graz im Jahr 2006. Nach diesem Einleitungssatz mögen sich die meisten eiligen Leser schnell anderen Dingen zuwenden, aber das wäre ein Fehler. Geboten wird die Auseinandersetzung mit verschiedenen ideengeschichtlichen Aspekten der „Knowledge Economy", die derzeit im Mittelpunkt vieler kontroverser wirtschaftspolitischer Debatten steht. Wie im Tagungsband betont wird, ist es trotz manchmal anderslautender Botschaften keineswegs eine revolutionäre Erkenntnis, das „Wissen" als Quelle des volkswirtschaftlichen Reichtums zu betrachten. So gesehen möchte man vielen Beiträgen zur „neuen" Wachstumstheorie gelegentlich ein bisschen mehr Bescheidenheit und vielleicht ein ausführlicheres Studium der relevanten Literatur wünschen. Der vorliegende Tagungsband bietet einen ausgezeichneten Einstieg dazu.

Die Tagungsbeiträge beschäftigen sich hauptsächlich mit den ideengeschichtlichen Anfängen einer Ökonomik des Wissens. Ernst Helmstädter und Dieter Schneider untersuchen die bahnbrechenden Studien von Hayek zur Rolle des Wissens für die wirtschaftliche Entwicklung. Yuichi Shionoya konzentriert sich auf die Arbeiten Schumpeters zur „Knowledge Economy", die auch in anderen Tagungsbeiträgen gewürdigt werden. Jochen Schumann entwickelt die „inneren Güter" von Heinrich von Storch zu einer weit gefassten Konzeption des Humankapitals und zeigt dabei die Verbindungen zu klassischen und modernen Beiträgen aus der Theoriegeschichte auf. Tetsushi Harada nimmt sich mit dem Begriff der „gemeinen Meinung" von J. F. E. Lotz einer Arbeit aus der älteren deutschen Gebrauchswertschule an. Elke Muchlinski betont den Zusammenhang zwischen Sprache, Bedeutung und Wissen und kritisiert, dass die moderne