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Public finance: fifty years of the second best—and beyond

A selection of papers presented at the 62nd Congress of the International Institute of Public Finance, held in Paphos, Cyprus

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Taking as its origin the famous article of Kelvin Lancaster and Richard G. Lipsey on the General Theory of the Second Best, published in the *Review of Economic Studies* in 1956, the IIPF Congress in August 2006 marked the 50th anniversary of the Second Best. Together with fundamental contributions by Samuelson, Boiteux, Bradford, Little, Meade, Corlett, Hague, Musgrave, and Harberger, this article established second best analysis as the prevailing approach to normative economic analysis. Beyond reflecting the many research off-springs of these seminal contributions, the Congress, as usual, covered virtually all topics within public economics. The programme included seven invited keynote lectures and 202 contributed papers. This conference volume contains three invited papers and five contributed papers presented in Paphos, and subsequently revised and refereed for publication.

Given the theme of the conference, it is appropriate that the first paper of the special issue is based on the first keynote lecture addressing the pioneering contribution of Lipsey and Lancaster. As it is a rare occasion that reflections on a 50 year old research publication can be delivered by the author himself, it is all the more appreciated that the speaker was Professor Richard G. Lipsey who shares with the readers his "Reflections on the general theory of second best at its golden jubilee." The paper describes the genesis of the general theory of the second best and discusses some of the criticisms that it has been met with. Going beyond the retrospective part, Richard Lipsey presents his own critical views on the subsequent developments and the current state and use of second best analysis.

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The two other keynote lectures appearing in this issue mirror the fact that tax analysis has been a major area for applications of second best theory and methods. In the last year of his term of office as President of the IIPF, Michael Keen delivered his presidential address bringing together the 50th anniversaries of the second best and the value added tax. Its ambiguous title "VAT attacks" testifies to the extent and speed of the spread of the VAT around the world as well as the objections levelled against it. The VAT has recently come under attack on three major fronts. It has been argued that the VAT is not an efficient tax instrument in countries with a large informal sector. In some quarters, especially in the United States, it has been argued that the introduction of an efficient VAT system may lead to over-taxation. Finally, it has been a strong concern that the VAT is susceptible to fraud. Keen discusses the relevance and validity of all these arguments. He emphasises the need to distinguish between arguments relating to the distinctive features of the VAT and arguments that would apply to any form of consumption tax.

Peter Birch Sørensen takes a broader tax perspective in his paper "The theory of optimal taxation: what is the policy relevance?" which addresses the cases for uniformity or differentiation of commodity taxes and capital taxation, respectively. Sørensen emphasises the need to strike a balance between the insights of theorists and the pragmatic arguments of practitioners. Recent contributions to the theory of optimal commodity taxation have provided a better foundation for selecting commodities to be tax favoured. At the same time, growing international mobility of capital tends to erode the conventional case for uniform taxation of capital. On the other hand, the paper warns against attempts at fine-tuning of differentiation. An important role for public finance economists should be to build a bulwark against ill-founded violations of tax neutrality pursued by and serving the self interest of special groups.

A tax issue that has been a central research topic in the Nordic countries and even outside in recent years is the Nordic dual income tax system characterised by a proportional tax on capital income and a progressive tax (typically with a higher rate) on labour income. The system requires a method—referred to as a split-rule—for dividing business income into (normal) capital income and a residual labelled earned income, which may also include above-normal return on capital. Vesa Kanniainen, Seppo Kari and Jouko Ylä-Liehdenpohja provide a theoretical analysis of the dual income tax with a split-rule in a model where potential entrepreneurs, differing in innate abilities, at an initial stage choose whether to become workers or entrepreneurs facing a risky return. Entrepreneurs who are sufficiently successful in the risky start-up period will make a subsequent expansion investment, while others quit. The authors emphasise the need to distinguish the tax effects on the mature firm and the tax effects in the start up phase in which the government does not share the potential losses incurred by the entrepreneur. The paper demonstrates that the dual tax system encourages (discourages) the establishment of new enterprises by entrepreneurs who anticipate high (low) profitability. It examines a range of effects on career and investment incentives, and identifies circumstances in which the dual income tax is neutral.

Seppo Kari and Hanna Karikallio address a different aspect of the Finnish dual income tax as reflected by the title "Tax treatment of dividends and capital gains and the dividend decision under dual income tax." The research is prompted by the observation that different tax rates on "normal dividend", "excess dividend" and capital gains induce tax-planning strategies. The authors set up a theoretical model capturing the financial and real investment policy of a closely held company and derive predictions supported by extensive empirical evidence. Kari's and Karikallio's research plays down the role and magnitude of real investment distortions highlighted in previous literature, shifting the focus to the company's dividend and financial policy. By manipulating the distribution of dividends and accumulating assets the entrepreneur transforms excess dividends into leniently taxed future normal dividends. The growth path of the firm under survey exhibits several non-standard features. It pays out dividends both during its growth path and mature phase, and it issues new equity at the same time as it pays out dividends.

With first best instruments ruled out, the choice of policy is often a question of comparing specific available instruments in a way that requires theoretical as well as empirical work. An example of such analysis is presented by Brink, Nordblom, and Wahlberg in their paper titled "A welfare analysis of Swedish child-care fee reform." The issue they address is the choice between a maximum child-care fee and increased child benefits in Sweden. With pre-existing distortions in the labour market, estimates of labour supply responses are essential for settling this issue. Based on their econometric estimates and social welfare criterion, the authors conclude that for plausible values of inequality aversion the alternative reform of increasing the child benefits would outperform the fee reform actually implemented in Sweden.

Induced by demographic changes in particular, there is growing concern in many countries with the income security of retired workers and the choice between public and individual responsibility for meeting retirement income goals. Robert Haveman, Karen Holden, Barbara Wolfe and Andrei Romanov make a contribution to a better basis for this debate by presenting empirical research on the extent to which the resources of a cohort of US retirees were able to meet various adequacy standards. They also simulate effects of four social insurance policy proposals on resource adequacy and on public fiscal liabilities. The title of their paper is "Assessing the maintenance of savings sufficiency over the first decade of retirement."

Modern public sector decisions are made by multi-level government, which generates fiscal externalities. In a paper entitled "Sickness absence and health care in an economic federation", David Granlund examines a regime where the central government taxes labour and provides sickness benefits while local government taxes labour and provides health care to cure people who would otherwise be eligible for sickness benefits and unable to pay taxes. The paper identifies circumstances in which local government has incentives to under- or over-provide health care, and discusses how the central government can induce local government to internalise its fiscal effects on the central government. It is demonstrated that vertical fiscal externalities remain even if all taxes are collected by local government.

The publication of this issue of the *International Tax and Public Finance* owes a lot to many people encompassing the scientific committee and the discussants of the IIPF Congress, and foremost the authors themselves and the referees whose great willingness to do extensive and careful work, subject to the very tight deadlines of the special issue, is much appreciated. Special thanks are due to the regular editors, John D. Wilson and Michael Devereux, for most helpful advice. Such a small sample of papers can hardly claim to be a fully representative cross-section of the presentations

at the Paphos Congress, but I hope it provides some flavour of the current research on second best and other key areas in public finance.

Guest Editor and Chair, Scientific Programme Committee