The Economic Journal, **114** (*November*), F536–F559. © Royal Economic Society 2004. Published by Blackwell Publishing, 9600 Garsington Road, Oxford OX4 2DQ, UK and 350 Main Street, Malden, MA 02148, USA.

BOOK REVIEWS

Taxation, Incomplete Markets, and Social Security: Munich Lectures in Economics. By Diamond (Peter A.). (Cambridge, Mass, and London: MIT Press, 2003. Pp. xviii+160. £18.50 hardback. ISBN 0 262 04213 4.)

Social security transfers resources across generations and plays a determining role in the optimality of intertemporal allocations. Diamond (1965) opened the debate on intergenerational transfers and the policy interventions that improve on market allocations.

The failure of competitive markets to support optimal intertemporal allocations can stem from two sources: (1) the divergence between the planning horizon of individuals and the horizon of economic activity, evident in economies of overlapping generations, and (2) market imperfections, such as missing markets for the allocation of risks.

Issues concerning the role and optimal structure of social security, funded or pay-as-you-go, arise and have been studied focusing on (1), even in the absence of additional market imperfections.

In this monograph, Diamond focuses on the second source for inefficiencies and argues that market failures and missing asset markets should play an important role in analysing pay-as-you-go public retirement plans. He discusses some important market imperfections and draws implications for the current debate on reforms of social security systems.

The monograph has three parts. The first part (chapters 2 to 4) considers redistribution of income across individuals within a cohort. Diamond shows how existing social security systems can be analysed by standard techniques of optimal taxation. The balance between distortions on one hand and the provision of insurance and the collection of revenue on the other plays a major role in Diamond's understanding of social security. Diamond examines a model in which households have time-inconsistent preferences and shows that, from a normative viewpoint, consumption when old should be less dispersed than consumption when young. He argues that this can be achieved when social security benefits are proportional to life-time earnings.

The second part (chapters 5 to 7) examines the role of missing markets for annuities in the design of a social security system. For whatever reasons, we do not see active trade in securities that pay contingent on an individual's survival. It is clear that in the presence of uncertainty about the time of death, the absence of such markets can lead to potentially large welfare losses. Of course this raises the question of how to optimally design retirement incentives for a population with different disutility of labour and different life-expectancies. Addressing these questions, Diamond considers a simple model with heterogeneous utilities for leisure and examines the optimal incentives for retirement. He shows that in an ideal system the implicit tax on work should decrease over time and reach zero at the point where all agents choose voluntarily to retire.

The last part discusses social security reform in Germany and explains how the theoretical analysis in previous chapters can be fruitfully employed in the current policy debate. This part of the book is in many ways the most interesting part. Diamond illustrates his theoretical findings using many facts about existing social security systems in European countries. He compares these systems and provides suggestions for improvements as well as insightful comments on reform-proposals that are currently being discussed.

The monograph is an important contribution to the current debate on the future of social security. But it does not provide a convincing economic rationale for a pay-as-you-go social security system as we see it in most industrial countries. While, correctly it points to several market failures, the monograph does not explain (or attempt to explain) why social security should be used to improve over the market outcome and why this cannot be achieved more efficiently by within generation taxation or saving incentives. The question then arises to what extent the current debate on social security reform can be understood without taking a stand on why the system exists in the first place. Diamond very explicitly states that he does not consider models of overlapping generations for his analysis, but it is not clear that one can then rationalise a pay-as-you-go system.

While the monograph takes up important aspects of social security, it omits all issues associated with economies of overlapping generations. At the end, the reader wonders which aspects are *quantitatively* more important and should play a more prominent role in the current reform debate.

The book should therefore not be viewed as a comprehensive analysis of social security, but, rather, as a very interesting discussion of particular issues associated with certain market imperfections.

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References

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Our Modern Times: The New Nature of Capitalism in the Information Age. By COHEN (DANIEL). (Cambridge, Mass, and London: MIT Press, 2003. Pp. 126. £16.50 hardback. ISBN 0 262 03302 X.)

How will the modern information revolution alter our personal lives and society? How will it affect the nature of work and managerial control within firms? What