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## **EUROPEAN JOURNAL OF MANAGEMENT AND PUBLIC POLICY**

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JÜRGEN G. BACKHAUS

## FISCAL SOCIOLOGY: THE STATE OF THE ART (PART II)

Fiscal sociology is a field which deals with the wider ramifications of a state's fiscal activities which can either not readily be captured by micro- or macroeconomic analysis or by financial institutional description. Take a simple example. A tax is levied on a particular good or service, there is a revenue, and there is an excess burden. In conventional analysis, the excess burden is considered a welfare loss. If the tax appears in the guise of a regulation, there may even be the additional monopoly loss, since the state does not receive any revenue. In mainstream analysis, the revenue that the state receives can be construed as being welfare-enhancing, one Euro to one, to the general citizenry, however it might be distributed in any particular case. Overall distributional effects could even out. We know, of course, and most citizens know the same, that this is not true. In fact, it is not a rough guess to say that for every Euro taken in by the state, two are taken out of the economy.

The question that now cannot be avoided is: what happened to the other Euro? It is patently not true that the second Euro can be represented in the second or shadow economy. The shadow economy is an interesting subject in itself, also part of fiscal sociology, but not the main focus of our analysis in these essays. The second economy, in many ways, is a clear case and can be analysed along the same lines as mainstream microeconomic analysis. The macroeconomic implications are also fairly easy to deal with. The second economy is like a cushion to the vicissitudes of the business cycle, and in this sense it helps the Minister of Economic Affairs (people are unemployed, but they spend), and they somehow hurt the Minister of Finance (people do not pay taxes on wages, but since they spend they spend taxes on whatever they spend, and hence politicians push for higher and higher taxes on consumption goods).

It cannot be denied that such a situation turns on a different development that further increases the second economy. If you suddenly have to live on subsistence payments, and perhaps a garden and some other activity, you will spend what you earn on what your household needs, if it does not break down in the process, but consumption patterns will also have to change. In the best of events, more of the necessities will come from the garden. But your car repair can also be gotten from your friend, who is equally unemployed.<sup>1</sup> It is, of course, true that

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<sup>1</sup> There is a book in my library which details no-cash goods and services (hotel, garage service, computer help and the like included) for the entire original 15 European Union-states. I am looking forward to seeing the version for the 25.

the apples produced in the garden and given in exchange for, let's say car-repair or baby-sitting, do not help the Minister of Finance immediately. But they do in this sense that the mother who was released from baby-sitting and could pursue her job, ends up paying somewhere close to 2/3 of her earnings in various forms. If she is more in the executive range of employment, she may either have a husband who is doing the household work: a rare species to find<sup>2</sup>, or she will simply pay, whatever she pays, even if she skirts social insurance payments out of her net, i.e. post-tax income. If she pays the lady from White Russia, who takes care of her children and perhaps takes on other chores, out of her cash income, she has already paid half of her income in taxes before she can even get to the cash nexus. Should she find a benign financial regime, she might be able to deduct documented household expenses from her income, if the nanny's pay were to be deducted, thereby endowing her White-Russian nanny with a certain, but in a way also uncertain claim on retirement benefits, this would bring the entire relationship back into the white economy.

Yet we would still be left with the question, where the other Euro went. Take for example the simplest of cases. A particular good is taxed, the supply curve shifts accordingly downward, and the demand curve is supposed to remain the same. The resources that are designed as the welfare loss have not somehow disappeared into thin air. They have been used for other pursuits, and we have moved from the production possibility frontier inwards into an unknown direction. We do not know how big the upsetting effect has been, we do not even know where the move has gone except for knowing that it has gone inwards. This unexplored drain is the area of fiscal sociology. In this issue of the *European Journal of Management and Public Policy*, you find examples in this field. After my own attempt at outlining the intellectual landscape of fiscal sociology, this time from the point of view of equity which after all is also a positive empirical category, not just a political one. Positive and normative theories are often confused in the most frequently used text book relevant for fiscal sociology, the one by Joseph Stiglitz. This is the topic of the second essay. The third article speaks directly to one of the core issues of this journal: good governance.

These essays were originally prepared for and read at the Erfurt Conference on Fiscal Sociology. Please note that this conference is open to all researchers in this field internationally and it is taking place in the second week of October, before the semester starts.

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<sup>2</sup> See „Prinzipalin oder Agentin: Die Organisation als ein Ort ökonomischer Austauschbeziehungen“, in Gertraude Krell und Margit Osterloh (Hrsg.), *Personalpolitik aus der Sicht der Frauen: Was kann die Personalforschung von der Frauenforschung lernen?*, München/Mering: Rainer Hamp Verlag, 1993, S. 206-229



JÜRGEN G. BACKHAUS

# THE IMPACT OF EQUITY DRIVEN POLICY MEASURES ON THE EQUITY OF THE STATE\*

## ABSTRACT

During the last decades, the idea that government can be and should be an effective instrument for the attainment of social justice and other ideals dear to social economists has come under powerful attack. Sometimes the attack is of a doctrinaire kind: designating areas where government should or should not intervene. In economics, this is often done in the tradition of identifying areas of “market-failure“. Sometimes, however, the attack is fuelled by serious shortcomings of well-intentioned governmental activities leading to poor results. Some economists have tried to identify these areas of poor government policy in terms of a theory of governmental failure. In this paper, a different route is chosen. Building on traditional public finance theory, the concept of public equity is developed as a measuring rod with which to judge the outcomes of policies guided by considerations of social equity or justice. This results in an analysis of a curious relationship. The purpose of this paper is to give an analysis of the curious relationship between the two equity concepts such as the one used in the finance (both public- and business-) literature on the one hand and in health economics on the other. The documentation of six equity induced health care measures is followed by a conceptual discussion of the different equity concepts in part I. Their impact on the equity of the state is analyzed in part II by using standard public finance and public choice theory. The paper concludes with an agenda for further research.

## 1. INTRODUCTION

The equity of a business corporation is generally understood to be the net present value of its assets, allowing for its liabilities, or - in short - its net worth. Equity is a measure of the value of all the means with which goods and services are produced, revenues collected, and obligations met. The equity of the state likewise is the net present value of revenue sources, again allowing for liabilities such as the public debt state equity is largely dependent upon the productive capacity of its citizens, their skills and their health. Curiously, in much of the health economics literature, equity is considered to be achieved if for example:

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\* I should like to thank John Davis, Justin Harriss and two anonymous referees for helpful comments

1. public prices vary according to personal gross income;<sup>1</sup>
2. there is “solidarity” between good risks and bad risks in public insurance schemes;<sup>2</sup>
3. technologies are economically assessed in terms of their “equity”, before being introduced into public services;<sup>3</sup>
4. responsibilities are diffused and limited as a matter of course, in order to guarantee “equitable” decisions;<sup>4</sup>
5. access to public supply of health care services is at the same time considered a basic human right and restricted by administrative procedures not subject to judicial review but administered in the name of “equity”;<sup>5</sup>
6. the general practitioners serve as entry barriers into the public health care system ensuring “equitable” access to services.<sup>6</sup>

Although these cases are exclusively drawn from Dutch sources, this is done for reasons of clarity and ease of exposition only. The principles discussed here resurface to different degrees in decisions on pricing and packaging public services in all the advanced western democracies, from Britain to the United States, Germany to France, with the smaller northern democracies certainly pioneering new applications and variations on basically the same principle. This is also the reason why examples drawn from these sources are better suited for a general discussion of the underlying principles than those from the larger democracies such as the United States, where the institutional realization will never be set forth in the pure forms observed in the smaller politically more homogeneous northern democracies.

During the last decades, the idea that government can be and should be an effective instrument for the attainment of social justice and other ideals dear

<sup>1</sup> Ministerie van Welzijn, Volksgezondheid en Cultuur, Financieel Overzicht van de Gezondheidszorg en Maatschappelijke Dienstverlening, 1986, 's-Gravenhage: Staatsuitgeverij, 1985. The principle is ubiquitous in the Netherlands not only for the compulsory social security System in its various wings (“volksverzekeringen”) but also for pricing public services not remotely related to health, such as nursery schools. Throughout the social security system, a pricing formula is crucial: a contribution is levied on the household according to (gross) income up to a maximum; elder people pay no contribution at all. See H.J.J. Leenen, H.D.C. Roscam-Abbing, Bestuurlijk Gezondheidsrecht. Alphen ald Rijn, Brussel: Tjeenk Willink, 1986, p. 139.

<sup>2</sup> H.D.C. Roscam-Abbing & F.F.H. Rutten, “Solidariteit versus Equivalentie-beginsel” (hoofdstuk 5). In: H.D.C. Roscam-Abbing & F.F.H. Rutten, Verleden en Toekomst van het Ziekttekostenverzekeringstelsel in Nederland, Deventer, 1985.

<sup>3</sup> Ger Haan, Effecten en Kosten van In-Vitro-Fertilisatie, Doctoral Dissertation. Rijksuniversiteit Limburg, Maastricht, 1989, p. 166.

<sup>4</sup> Publicly authorized corporate forms are introduced which resemble foundations but lack endowments and are exempt from liability. These institutions implement delicate policy measures.

<sup>5</sup> Ger Haan (1989) p. 163.

<sup>6</sup> M.H.L. van Tits, “An Experiment with Financial Incentives for General Practitioners in the Netherlands”. Research paper for “The Joint Meeting on the First European Conference on Health Economics” Barcelona, September 1989.

to social economists has come under powerful attack. Sometimes the attack is of a doctrinaire kind: designating areas where government should or should not intervene. In economics, this is often done in the tradition of identifying areas of “market-failure”. Sometimes, however, the attack is fuelled by serious shortcomings of well intentioned governmental activities leading to poor results. Some economists have tried to identify these areas of poor government policy in terms of a theory of governmental failure.<sup>7</sup> In this paper, a different route is chosen. Building on traditional public finance theory, the concept of public equity is developed as a measuring rod with which to judge the outcomes of policies guided by considerations of social equity or justice.

This results in an analysis of a curious relationship. The purpose of this paper is to give an analysis of the curious relationship between the two equity concepts such as the one used in the finance (both public- and business-) literature on the one hand and in health economics on the other.

The purpose of this paper is to give an analysis of the curious relationship between these two concepts of equity. The documentation of six equity induced health care measures is followed by a conceptual discussion of the different equity concepts in part I. Their impact on the equity of the state is analyzed in part II by using standard public finance and public choice theory. The paper concludes with an agenda for further research.

## 2. THEORY: EQUITY IN BUSINESS AND PUBLIC FINANCE

In business finance, equity is the residual value of a company’s assets after all outside liabilities (other than the shareholders’) have been allowed for. In public finance, a country’s equity is the residual value of its assets after all outside liabilities (other than the internal debt the State owes to its citizens and other institutions inside its jurisdiction) have been allowed for. The assets of modern democratic states consist largely of claims in the form of taxes, of which most are either levied on labour (income taxes, payroll taxes, social security taxes) or consumption. In addition, most states hold land or other natural resources the value of which tends to increase with economic development; an increase that sometimes is more than offset by a larger relative increase of the public debt. In assessing a country’s equity position, it is not correct to compare the foreign debt with gross national product. The reason is that the foreign debt cannot be serviced out of the total gross national product, which is not by itself at the disposition of the State. Only that part which can be levied through taxation is available for servicing the foreign

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<sup>7</sup> In creating a mirror image to Francis Bator’s “The Anatomy of Market Failure” (Quarterly Journal of Economics, 1958), Charles Wolf jr. developed his theory of governmental failure, first in an article entitled “A Theory of Non-Market Failure”, Journal of Law and Economics, 1979 and then in his book *Market or Government: Choosing between imperfect alternatives*. Cambridge, Massachusetts: The MIT Press, 1988.

debt. The yield of any particular tax tends to be subject to decreasing returns, once a tax rate has reached some level, the precise location of which is heavily dependent on the relationship between benefits received in consideration of the taxes paid.<sup>8</sup>

At this level, further tax increases are to the detriment of the taxing government. Furthermore, the fecundity of the tax base also depends on the size of the internal debt, since the larger the internal debt (given a predetermined expenditure level), the smaller can be the tax financed outlays for public production of goods and services, on which the fecundity of the tax base depends at least in the long run. In estimating the assets of a state, one therefore has to start with the net present value of its future taxes, which has to be adjusted downwards *ceteris paribus*, the higher the public share in gross domestic product, the higher the share of public debt in gross domestic product, and the less attractive the tax/benefit ratio is to the most important groups of taxpayers. The last three aspects seem to be particularly relevant for the small northern democracies *e.g.*, the Netherlands and the Scandinavian countries.

Apart from the three considerations already mentioned as determining the equity of the state by virtue of affecting the net present value of the state's assets, there is a fourth important aspect which has always figured prominently in public finance analysis for as long as the discipline has been subject to economic discourse. The population of a state has to be in good health, since the better the health state of a population, the higher the revenues and the lower the outlays will be and, conversely, the less healthy a population, the higher the outlays of the state on promoting health and health care, and the smaller the revenues from people who produce or consume.<sup>9</sup> This basic relationship yields the proposition that, in public finance, the better the health state of a population, the better is that state's equity position.

The (explanatory) *benchmark principle* follows that measures to improve the health state of a population should be carried out with tax financed funding to the extent that the marginal outlays are covered by expected marginal tax revenues.

## 2.1. DISTRIBUTIVE EQUITY AND SOME THEORY OF TAXATION

This simple policy principle, although probably acceptable as a base line to any student of the matter, is not sufficient to *explain* either the extent or the structure of health care provision in contemporary developed economies with western style democracies such as the United States and Canada, Germany,

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<sup>8</sup> The standard Laffer curve is too simplistic a tool for this analysis, since benefits are ignored in this relationship.

<sup>9</sup> See Jürgen Backhaus, *Die Finanzierung des Wohlfahrtsstaats (Inaugural Lecture)*. Maastricht: Rijksuniversiteit Limburg 1989, p. 7 (Dutch version p. 10). Referring to Christian (Freiherr von) Wolff, *Grundsätze des Natur- und Völkerrechts*. Halle: Renger, 1754, III, § 1022.

Britain or the northern democracies such as the Scandinavian countries and the Netherlands. The literature discussing these health care systems, which is largely synonymous with the new discipline of health economics, has developed a completely different concept of equity which has originally been taken from public finance analysis but meanwhile has taken on a life of its own. In addition to the standard notions of financial equity discussed above, there is also the notion of distributional equity which, following the classical textbook by the Musgraves, acknowledges three fiscal functions of the State, *viz.* the allocation function, the distribution function, and the stabilization function.<sup>10</sup> Since taxes are determined in a political context, public finance analysis cannot ignore their distributional consequences. Musgrave & Musgrave spell out the relationship between allocation and distribution in public finance in clear terms:

*But the theory of efficient factor use by itself is not a theory of distributive justice. For one thing, the proposition that factor allocation should be based on efficient factor pricing does not require that the final distribution of income among individuals be set equal to the proceeds from sales of their factor services to the market. The two can be separated by intervention of the distributive branch of the budget. For another thing, the ultimate concern of justice in distribution is with distribution among individuals or families and not among groups or factors. Factor shares are only loosely related to the interfamily distribution of income. While it is true that capital income accrues more largely to high income families and wage income more largely to low income families, there are important exceptions to the rule. The problem of distribution among individuals or families must thus be addressed directly. (p. 74).*

The cases discussed below are not covered by this exception. Health affects neither capital nor natural resources, but only one factor of production: labour; and it affects persons in both their ability to produce and to consume. The question of justice, then, is *eo ipso* less one of distribution but one of allocation, *i.e.* of the *efficient* use of the available resources in the interest of optimizing the health state of the population.

In the theory of taxation, the concept of equity typically takes this basic form:

- a. are taxpayers (individuals, households, or firms) differently burdened according to differences among them, such as differences in their ability to pay, their benefits from the tax financed expenditure or some other relevant criterion? This concept is called *vertical equity*.
- b. are taxpayers differently burdened although they are equal? This concept is called *horizontal equity*.

If the question is reduced to the criterion of ability to pay only, the dual concept takes on the form:

<sup>10</sup> See Richard A. Musgrave & Peggy E. Musgrave, *Public Finance in Theory and Practice*, first edition 1973, New York: MacGraw-Hill, 1989 (5), chapter 1.

- a. *vertical equity*: how does the tax burden vary across taxpayers (individuals or households) of different means? and
- b. *horizontal equity*: how does the tax burden vary across taxpayers (individuals or households) of identical means?

The oldest equity principle in public finance is the straightforward *benefit principle*, re-emphasized by Knut Wicksell.<sup>11</sup> The dual equity principle then reads:

- a. *vertical equity*: does the tax burden vary across taxpayers (individuals or households) according to the different benefits they derive from the expenditure?
- b. *horizontal equity*: do taxpayers (individuals or households) have to carry different tax burdens although they derive the same benefit from the expenditure?

The measure or policy is equitable if the first question (a) is answered in the affirmative and the second (b) in the negative.

In health economics,<sup>12</sup> we sometimes find that the concept of equity is split into different concepts depending on whether they refer to the expenditure or the revenue side. On the provision side, we find the notion that a vertically equitable provision of goods and services depends on the *need* of the individuals concerned; the more intense (express?) the need, the more services should be provided. On the revenue side, on the other hand, *ability to pay* is often invoked as the principle of vertical equity: the better the ability to pay, the more a particular taxpayer (individual or household) should contribute. In practice, this criterion is translated into something else, equating ability to pay with *gross income*. Since the appropriate definition of income for matters of taxation is important both from an allocative and a distributive point of view, this problem is taken up in the next section.

## 2.2. THE CONCEPT OF INCOME IN TAXATION THEORY<sup>13</sup>

In economics, categories and terms are defined with respect to the models in which they fulfil a function. In some disciplines, such as law, terms can be significant as such, independent from their context. They can add significance to a certain context.<sup>14</sup> As it happens therefore in economics, terms are

<sup>11</sup> See Knut Wicksell, *Finanztheoretische Untersuchungen*. Jena: Gustav Fischer, 1896. James Buchanan follows this tradition.

<sup>12</sup> See e.g. Jeremy Hurst, "Equity in the Delivery of and Payment for Health Services. ch. 7. In: J.W. Hurst, *Financing Health Care in the US., Canada. and Britain*. Kings Fund 1985.

<sup>13</sup> See originally Gustav Schmoller, "Die Lehre vom Einkommen in ihrem Zusammenhang mit dem Grundprinzip der Steuerlehre". In: *Zeitschrift für die gesammte Staatswissenschaft*, 19, 1863, pp. 1-84.

<sup>14</sup> See Jürgen Backhaus, *Mitbestimmung im Unternehmen*, 1986, pp. 145-146, with further references to Ch. Wolff and J. Esser.

completely dependent upon the context in which they are used. The context is typically a model. Terms such as capital, profit or income take on completely different meanings depending on whether they are used in a macro-economic model, a micro-economic model or, as in the case under consideration, the theory of taxation. In taxation, income is a permanent magnitude on which a permanent charge can be levied. Since we are concerned with permanent sustainable financial streams, the relative proportions (*e.g.* of the tax in relation to the income) have to remain stable. This implies not only that the tax cannot exceed certain bounds beyond which it would reduce the stream of income to be taxed in the future and thereby endanger the sustainable yield; the principle further implies that income as an economic magnitude cannot be seen independent from the sources which generate income and from the economic unit which provides the structure in which income is generated. In simple economic terms, we define income in terms of a functional relationship such as equation (1) which relates income to its determining variables.

$$Y = f(C, S, R, E, H) \quad (1)$$

Y – Income

C – Capital

S – Skills

R – Incidental Revenues

E – Incidental Expenditures

H – Health

Equation (1) shows the level of income to depend on the capital endowment used, the human capital or level of skills<sup>15</sup> employed, incidental revenues such as bequests, incidental expenditures such as those for accidents and sickness, and the health states of the individual(s) involved in generating the income flow. The permanent stream of income depends only on capital, skills and health, since the incidental revenues and expenditures will affect one of the other variables but not permanently affect the income stream.

$$T=f(Y) \quad (2)$$

T – Tax Revenue

Equation (2) is straightforward in simply relating the permanent tax revenue and the permanent income stream. This functional exposition readily yields two general principles.

<sup>15</sup> This refers to an output variable; “schooling” as used in van Doorslaer (1987) would be an inappropriate proxy. See Eddy K.A. van Doorslaer, *Health, Knowledge and the Demand for Medical Care*, Assen/Maastricht: Van Gorcum, 1987.

Principle 1: The unit of taxation is the unit generating the income.

Principle 2: Taxable income is the permanent or sustainable stream of income after allowances for all those expenditures which have been made in order to leave the income generating unit intact.

### 2.3. APPLICATION

We can now apply the above analysis to the problem of financing a public health care service by means of a tax on income. Let us assume that the unit of taxation is correctly identified as the household which generates a stream of income and maintains its productive assets. Self employed households will typically differ from households whose members are dependently employed with respect to the size of their capital stock. Both types of households invest in maintaining or improving their skill levels and their health states. The taxable income, consequently, has to be corrected for those expenditures on capital maintenance, education and health. This implies that the taxable income is an appropriately defined *net* income variable, and not the *gross* income variable we previously encountered.

Expenditures on public health care provision depend on the demand for health. The household demand for health, in turn, is a negative function of the opportunity costs of treatment. The opportunity costs of treatment are the higher, the larger is the improvement in health expected from the treatment and the smaller are the expected costs of the treatment. In a market environment of health care provision, the household demand for health will be a typical negatively downward sloping curve, with the position of the demand curve largely dependent on the health states of the members of the household, and the quantity of health care services demanded depending on the price charged. In public health care provision, if no price is charged to the household, the position of the demand curve will again be largely dependent upon the health states of the household, but the quantity demanded will depend on those costs of the rationing mechanism employed that fall on the household as a consequence of seeking treatment. If the rationing mechanism is a simple queue requiring time spent in order to receive the treatment, the cost borne by the household will be in terms of income foregone and a sub-optimal health state of the member seeking treatment. Both negatively impact on income. If the rationing device does not literally require time spent in waiting for the treatment, but simply lags seeking and receiving treatment, the cost borne by the household is the opportunity cost of the suboptimal health state of the member(s) seeking treatment and has a depressing effect on household income. The circle is closed by noting the following

*Proposition 1:* The reduction in household income due to gross income based pricing policies in public health services will also reduce the revenue from a tax on income and consequently reduce the equity of the state as defined above.



#### 2.4. INCOME INVARIANT WITH HEALTH

The preceding discussion was based on the assumption, expressed in equation (1), that the income a household can generate will depend on the health states of its members. In that case, the stream of sustainable income on which taxes can be levied will decrease if health states remain impaired. There is a class of households for which this assumption does not hold true. Inactive households, whose income is based on some type of claim such as a pension, can maintain their income stream irrespective of capital maintenance and retention of skills provided health states remain above a sustainable minimum. This condition is expressed in equation (3).

$$Y = f(C, R, E, H) \quad (3)$$

Household income now depends only on the fixed claim  $C$  which can be expressed as a fixed capital stock, on incidental revenues and incidental expenditures as well as a minimum state of health. Note that incidental revenues will now also count as income, since (and as long as) they are not re-invested into the income generating ability of the household. The household's economic situation is sustainable as long as the sum of permanent consumption and incidental expenditures (such as those on health maintenance) does not exceed the fixed permanent income flow.

The analysis points to an important *source of income taxation*, when inactive households do not re-invest incidental revenues in order to enhance their income generating ability. Curiously, as pointed out above (see footnote 1), this very group of households tends to be exempted from certain income based social security taxes altogether.

#### 2.5. STABILIZING AND DE-STABILIZING PRICING AND FINANCING FORMULAE

If health care services are delivered in a market environment, decisions on how to provide and package services and how to price them simultaneously solve the funding problem. Services which do not generate a sustainable revenue stream will be discontinued. The system is a self-equilibrating one.

In the public sector, decisions on financing and providing services obviously have to be synchronized too. Often, political considerations make it impossible to use a straightforward market based pricing formula. A particular service may be provided publicly for the very reason to operate it differently from a market operation. In this case, a different formula driving decisions on funding and quantity and quality of provision of Services has to be used. The classical formulation of the equity principle as given above provides for such a formula. In the Wicksellian formulation, roughly homogenous groups of beneficiaries subscribe to a particular public service and generate the necessary funding according to their willingness to pay.

*Proposition 2:* Willingness to pay obviously reflects ability to pay, but it also reflects a judgement on service. This information is of crucial importance in order to maintain quality standards in the public sector, since the public sector service cannot rely on the same signals a market based operation receives.

A benefit principle therefore requires that subscriptions to the service be open to renewal or refusal. Membership in a particular group or fund cannot be compulsory; the state may only impose a duty to join at least one such a group or fund, provided these offer service and funding profiles that are sufficiently different one from the other in order to provide for a meaningful choice. The classical equity principle allows for a self sustaining provision of a public service. If a group becomes smaller as subscriptions dwindle and consequently the sustaining fund starts shrinking, the service either has to be repackaged and improved, or it will gradually lose importance and ultimately disappear, yielding room for a public service better matching subscribers' expectations with respect to service profiles and quality and their willingness to pay for these services.

The commonly used funding principle "provision according to need, financing based on gross income" generates a completely different constitutional design. On the supply side, there is no provision whatsoever to filter consumers' decisions into responses with respect to the quality and profile of services. On the funding side, as demonstrated in the preceding section, the formula cannot generate a sustainable stream of revenues since it systematically erodes the income generating ability of households by not taking account of the difference between stocks and flows.

The formula then combines at least three destabilizing elements:

1. in the long run, gross income taxation destabilizes its own funding source.
2. since there is no feedback with consumers, service profiles, quantity and quality are likely to match poorly with consumers' expectations and willingness to pay.
3. since the formula disjoins decisions on funding and decisions on production, it cuts through the most important self-regulating mechanism to control costs. Permanent cost increases are the likely consequence.

In conclusion we can note:

*Proposition 3:* Equity considerations in funding the provision of public services, such as health care services, can have important consequences for the quality, the quantity and the profile of services as well as for the costs of their provision. Equity driven funding formulae can either stabilize or destabilize the long term provision of a service. These formulae can provide incentives for cost control and quality maintenance, but they can also do the opposite. Far from being of a purely distributive nature, equity based funding formulae can have important allocative consequences.

### 3. SOCIAL JUSTICE AND PROVISION ACCORDING TO NEED

It is sometimes suggested that in such areas as health care, social justice requires provision according to need and, therefore, considerations of allocative efficiency have to be relegated to secondary importance. Such a notion is, however, faulty, since allocative efficiency and justice cannot be juxtaposed as opposites. Consider the following quote from John Rawls' *A Theory of Justice*:<sup>16</sup>

*The main problem of distributive justice is the choice of a social system. The principles of justice apply to the basic structure and regulate how its major institutions are combined into one scheme. Now, as we have seen, the idea of justice as fairness is to use the notion of pure procedural justice to handle the contingencies of particular situations. The social system is to be designed so that the resulting distribution is just however things turn out. To achieve this end it is necessary to set the social and economic process within the surroundings of suitable political and legal institutions. Without the proper arrangement of these background institutions the outcome of the distributive process will not be just. Background fairness is lacking. I shall give a brief description of these background institutions as they might exist in a properly organized democratic state that allows private ownership of capital and natural resources (...). This is achieved by policing the conduct of firms and private associations and by preventing the establishment of monopolistic restrictions and barriers to the more desirable positions. Finally, the government guarantees a social minimum either by family allowances and special payments for sickness and employment, or more systematically by such devices as a graded income supplement (a so-called negative income tax)... Since the market is not suited to answer the claims of need, these should be met by a separate arrangement. Whether the principles of justice are satisfied, then, turns on whether the total income of the least advantaged (wages plus transfers) is such as to maximize their long-run expectations (consistent with the constraints of equal liberty and fair equality of opportunity).*

In Rawlsian terms, the maximum rule as applied to health care provisions suggests that the system respond in an optimal fashion to the health care demands of those most in need to be taken care of. This requires two categorically distinct sets of policies. On the one hand, the health care system has to be structured so as to achieve allocative efficiency. On the other hand, health care demand has to be made effective in the sense of matching willingness to pay with ability to pay. These two results, however, cannot be achieved by the same policy, such as the funding formula "provision according to need, financing based on gross income". The result can only be achieved if the transfer problem (ensuring effective demand) is separately dealt with from the allocation problem (ensuring optimal health care).

### 4. SIX CASES: AN ILLUSTRATION

In looking at the six cases documented in the discussion, the various equity notions can be further illustrated. One should keep in mind that the concept

<sup>16</sup> London, Oxford University Press, 1972, Chapter 43.

of equity, once we move beyond the benefit principle, can be substantiated with almost any conceivable criterion that comes to mind. The benefit principle captures all the various dimensions of burdens and benefits as they are valued by the individuals or households. Once we move beyond the benefit principle, proxy-indicators have to be chosen. Among these proxies, we can look at the distribution between different age groups and generations, between the public and the private sector, between the gender groups of distribution, according to geographical location, with the contrast between the city and the country on the one hand, but also (often overlooked but important in the context of “1992”) the contrast between the citizens living within the jurisdiction and those immediately neighbouring it on the other, the effects on families on the one hand and single household units on the other, the distributive effects between the healthy and the sickly *etc.* The list can be continued indefinitely along the entire spectrum of social indicators.

#### 4.1. CASE 1

The effects of levies on gross household income with exemptions for inactive households, employed as a means to finance social services, on the overall health state of the population have been discussed extensively in the previous section. The financing formula is deficient for sustaining the financial needs of the service for which it is used, but it also generates adverse effects on the provision side, favouring the inactive households over the active households. The most productive consumers are least well served. The formula is in open violation of the benefit principle. Its additional equity implications are also problematic. Although there is a certain preferential treatment of the elderly who are exempt from the levy, the same is true for other non-active individuals and households who receive some form of public assistance. The intergenerational equity is questionable, as the next generation is likely left with poor health states and a badly functioning system. The system is tilted towards public provision at the expense of private initiative, but the financial burden is also predominantly carried by public sector employees who are least able to avoid the levy. The formula seems to be neutral with respect to gender, but not with respect to geographical location. In particular, it would be interesting to compare the tax/benefit ratio's in a European context.

Health, as an economic good, is a complement to both labour and consumption. Deteriorations in the health state of a population therefore negatively affect the taxing power of the state where it is strongest: income taxes including social security and payroll taxes and consumption taxes such as the value added tax.

*Proposition 4:* If the gross income funding formula indeed has a negative impact on the health state of the population, it also negatively affects the tax base and thereby the equity of the state.

The question here has been analysed in conjectural terms; it would be important to follow this exploratory analysis up empirically.

#### 4.2. CASE 2

The concept of solidarity between good and bad risks flies in the face of received insurance theory. The origin of the concepts can best be demonstrated with the following stylized example. Consider a public insurance scheme which is compulsory up to a certain income level. The levies depend on age and gross income, the outlays on health states. In addition, a private insurance market remains. The predictable result has the “good risks” migrate to or remain with the private insurance system, whereas the “bad risks” accumulate in the public sector. From the point of view of allocative efficiency, the correct solution is to adopt the classical benefit principle and try to discriminate as deeply as possible between the different risk groups. If distributional concerns are important, which no doubt they are in the case assumed, public assistance (in the form of subsidies or tax credits) can be attached to the bad risks and left to migrate to whichever insurance pool proves most attractive. Since the public insurance scheme is likely to be exempt from taxation, attaching tax benefits to bad old age insurance risks could prove to be a powerful instrument for keeping them in the private sector. An allocation problem remains, however, as long as the system lacks incentives to contain the costs of bad risks, *i.e.* positive incentives to maintain health in as good a state as possible, granted to both insurees and insurers. The principle of discriminating among risks serves this function, with poor risks facing higher premiums. The principle of solidarity neutralizes this incentive system and creates impediments to reducing costs by pooling appropriately defined risk groups towards which health measures can be more directly pointed.

*Proposition 5:* The adverse effects of the principle of solidarity between good and bad risks on both health states and costs to the insurance system can be substantial.

Again, these effects can be empirically established either in terms of a long term experiment or in terms of comparing the present system with an international sample where cases can be pooled according to risks and costs.

#### 4.3. CASE 3

*Assessments of medical technologies prior to adoption* substitute the medical specialists’ and the patient’s judgement by that of the economist who undertakes the technology assessment study. Such a study is necessitated by the dissolution of funding and treatment decisions consequent to the split equity criterion (needs/means). The allocative consequences of such equity induced technology assessments can best be demonstrated by taking up a well done study and looking at its major implications. In principle, such a study can at best lead to the exclusion of an advanced technology which amounts to an artificial restriction of the production possibility frontier of the medical specialist who administers a treatment. The restriction is made necessary because the treatment, under the split equity criterion, proceeds without due regard to costs. It should be clear, however, that by imposing an artificial restriction,

at least for some groups of patients the optimal treatment (even with regard to costs) is excluded. Consequently, and considered collectively, the group of insurees does not get the maximum return on its compulsory insurance contributions, quite irrespective of income position.

In fact, even well done studies can make a mockery of economic analytical techniques. Consider the case of two treatments for fertility. One treatment has traditionally been available under the state system, the other being new has not. Both treatments complement each other in so far as they yield better results with different groups of patients. This should imply that for equity reasons, both treatments should be made available. But the final conclusion of a technology assessment study on a new fertilization treatment reads otherwise; after referring to the general context of funding the various treatments, the author concludes: "Part of the discussion will concern the question whether fertility treatment – successful or not – increases the couple's health situation. Additional life years for the treated couple are not to be expected and an increase of the couple's quality of life in the long run is questionable." (Haan, 1989, 166). The revealed preferences of couples seeking treatment indicate clearly that improvement in the couple's expected general level of wellbeing, *i.e.* an increase in the couple's quality of life is clearly and unambiguously expressed by those concerned. What is not available is a cost oriented assessment. The author's conclusion, however, is nothing but a third person's superimposition (in disguise) of his own judgement. Instead of trying to establish the expected benefits from treatment by looking at parents' willingness to pay, if necessary in opportunity cost terms, average life years are used, a measure which does not express utility. In addition, the most important person for which this treatment is undergone, the child to be conceived and to be born, does not figure at all.<sup>17</sup>

#### 4.4. CASE 4

In market based economies, one of the characteristic features is the synchronization of control and liability in order to contain the damage from harmful

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<sup>17</sup> An anonymous reader has offered the following criticism at this point: "The case of fertility treatments reveals another weakness in the concept of the state's equity. Just as the Hahn quotation ignores benefits reflected by willingness to pay, the state's equity will likely fall if fertility is enhanced and labour force participation, if primary care taken, is reduced. Clearly, consumer's rent (Oster plus) and related welfare concepts should be considered in reevaluating the concept of the state's equity".

If this suggestion were followed, the concept of the state's equity would no longer be empirically relevant. We can clearly measure state revenues but we cannot measure a couple's increased welfare from having a child; in addition, this welfare is privately experienced and should not be related to the state. It is important to avoid the velocity of depicting the state as the maximize of some social welfare functions. The equity consequences of additional (voluntary) conceptions should be straight forward and plausibly assumed to be positive; although there may be a temporary reduction in labour force participation by a parent, the new child will eventually join the labour force and, if healthy and skilled, contribute to the state's net worth.

decisions. When the harm from a decision could be foreseen and avoided by taking appropriate care, the person who was able to foresee the harm and able to take the appropriate steps, *i.e.* the person who was in control will also be held liable for the consequences of his action or lack of actions.<sup>18</sup> In public health care provision, as we have seen earlier, there is substantial potential for harmful decisions; we also observe at the same time that the extent of liability is minimal and the synchronization of control and liability almost non-existent. From an economic point of view, this situation needs to be remedied. If for instance a patient suffers a serious injury because a doctor did not administer the necessary treatment, which he failed to do because, in order to administer the treatment, according to state regulations, he needed the written consent of two colleagues whom he could not reach because they were tied up in meetings, this doctor cannot be held liable for the injury imposed on the patient; nor can the full damage remain with the patient, if an efficient allocative result is to prevail; rather, the principle of synchronizing control and liability requires to make those jointly and severally liable who contributed to passing the regulations causing the problem – tying up doctors in meetings and requiring a written consent to engage in professional activities – in the first place.

By law, however, the nexus between control and liability is often weakened in every conceivable form. Consider the case of a treatment program<sup>19</sup> which substitutes a cheap and highly addictive drug for an expensive and (almost) equally addictive drug as a matter of treatment, dispensing the cheap drug for free. Irrespective of medical detail, the practice sounds questionable and might give rise to legal recourse from parents and dependents of addicted patients thus treated. We find the program being administered purely with government funds but through a private “foundation” without endowment, *i.e.* an agent with very shallow pockets, who consequently cannot be held liable. As instances like these multiply in a particular health sector, the adverse consequences of such unchecked treatments can amount to very substantial damage for that economy and society, damage for which nobody will be held liable in any form. The equity of the state and the wellbeing of its citizens can be substantially impaired, with nobody being held liable for such impairments.

By way of example, the “Consultatiebureau voor Alcohol en andere Drugs in Limburg” distributes methadone to about 1500 drug addicts in Limburg. It has no medical doctor on its regular staff. The institution is chartered as a foundation (“stichting”) with an endowment of 100 dfl. Its revenues stem exclusively from various public bodies in the form of contract-subsidies.

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<sup>18</sup> See also J.H.R. van de Poel, *Judgment and Control: Individual and Organizational Aspects of Performance Evaluation*, Groningen: Wolters-Noordhoff, 1986.

<sup>19</sup> See Edward Jay Epstein, Methadone: The Forlorn Hope. *The Public Interest* 36, 1974, 1-24.

#### 4.5. CASE 5

*“For several years, Dutch health authorities have been trying to develop a policy of deferred adoption of new techniques in the social insurance package. In the try-out period, the technology is provided only on a limited scale under defined conditions. Simultaneously, a cost effectiveness analysis is carried out.”* (Haan 1989, p. 163).

The author continues by explaining that the new technique will first be used in a limited number of hospitals, while the study is underway.

From an economic point of view, this case adds an aspect beyond what has already been discussed under case 3 which is relevant to the principle of synchronization of control and liability just discussed. The straightforward results of the practice, namely the artificial slowdown of medical technology adoption is justified on equity grounds; a doubtful justification at best, since the negative consequences are likely to be distributed in a most inequitable way over those covered by the public health insurance system. In addition, however, the implementation is inequitable in itself, preferring patients in the vicinity of hospitals chosen over those in districts not chosen. Most importantly, however, although a procedure is followed, this procedure cannot be challenged in an appropriate review process by those concerned: doctors and, above all, patients refused the treatment. The absence of such a review procedure further weakens incentives to prevent harm (from lack of treatment offered).

By imposing a cost *effectiveness* study instead of a cost *benefit* analysis, a further step is taken which detracts from the equitability of the procedure. As we have seen in the discussion of case 3, cost effectiveness studies will use proxies for individual valuations and consequently do not take into account the most important aspects which have probably led to the development of the new treatment techniques analyzed. By systematically disregarding consumers' rent, the procedure is already tilted towards the inequitable result of not adopting a new technique. Again, the allocational inefficiency in the public health care system can be substantial consequent to this type of procedure.

#### 4.6. CASE 6

The idea to strengthen general practitioners' role as gate keepers (to the more costly treatment of specialists and in hospitals) was conceived after it became apparent that in the Netherlands, general practitioners rationally responded to the following financial arrangement. For patients covered under the public insurance fund, the general practitioner received a flat annual recompensation. For patients covered under private insurance programs, remuneration was according to time spent and treatment category. The predictable result, referral of time-consuming patients covered under the public fund to the more expensive care by specialists and hospitals led to the adoption of an



experiment in which general practitioners received a financial incentive for making fewer referrals than a general average. The experiment resulted in a selective re-arrangement of the referral practice, with those general practitioners participating in the experiment referring fewer children and engaging in more smaller treatments (like audiograms) and more prescriptions which had previously been left to the specialists.

Again, the experiment was accompanied by a “scientific” study. The root of the problem taken up with this experiment lies in the differentiation of pay schedules. This led general practitioners to take on more treatment of privately insured patients relative to publicly covered patients, opening the “gate” to publicly covered patients to more expensive treatment methods, while tying privately insured patients up for a longer time in the general practitioner’s office. In principle, this difference of treatment based not on medical conditions but on medical coverage flies in the face of the principle of equity, however conceived.<sup>20</sup>

A patient appearing in front of a doctor and showing symptoms that could, in principle, reflect different conditions will receive different treatment depending on whether he appears before a general practitioner or a specialist. The general practitioner is more likely to proceed with a cure even if the underlying condition has not been established with certainty than the specialist; therein lays the basic difference in approach. The advantage of the general practitioner is in expediency, the relative advantage of the specialist lies in accuracy. This refers to both decisions about treatments and the delivery of the treatment itself; the specialist will have more expertise in the limited number of treatments rendered than the general practitioner. The trade-off between expediency and accuracy cannot be avoided; it calls for an optimization on the basis of all the available knowledge. Knowledge can come from two sources, the doctor(s) involved and the patient. In appointing the general practitioner as the gate keeper of the system, a source of knowledge is blocked with the foreseeable result that the trade-off cannot be optimally resolved. By additionally offering financial rewards to a general practitioner for non-referral, the decision-making process is further tilted and the patient’s position weakened, also because he faces a monopoly provider of medical services with the general practitioner whereas he faces an oligopolistic supply side of medical services if granted access to the specialist immediately. The likely consequence of such an approach, again, is a suboptimal provision of medical services, lower quality of medical services rendered than is possible with the amount of resources claimed by the system. Again, the allocative consequences of this equity driven pricing formula can be substantial. Interestingly enough, the doctors involved in the experiment tried to contain the possible damage by absorbing more routine tasks into their practices and relying to a larger extent on medication than on further tests and on the more focussed

<sup>20</sup> Most likely, the practice is also incompatible with the Hippocratic oath.

drug treatment the specialist can provide. The inter-generational equity impact of absorbing more pediatric cases into the general practitioner's office are worthy of further scrutiny. In conclusion a detailed discussion of the six cases selected gives us still more reason to expect that equity driven measures in public health care provision, far from being purely of a distributive nature, can have important allocative consequences.

## 5. AN AGENDA FOR FURTHER RESEARCH

The considerable mismatch between the results derived from standard public finance analysis and those found in the six cases discussed above raises the question of whether received public finance analysis is at all adequate for understanding the operation of the health sector in modern democracies of the small northern European type. One of the classics in the theory of taxation, Emil Sax (1924) offered this word of caution in applying his tax theory:

*Our theory is based on normal taxation. Quite a different matter are confiscatory taxes aiming at a modification of the income and wealth of certain population groups. The reasons for such interference with the existing property distribution are exogenous to the theory. Nor has the question of absolute and relative amount of such taxes any relevance, since it is subject to a priori decisions in the light of political purposes and political power. (Sax 1924, cited from the translation p. 187).*

Is the set-up of the public health care provision to be explained, not in terms of equity but in terms of redistributing income and wealth through the deep regulation and monopolization of health services in the public domain? If this were so, one would have to show that the design of the public health service in a country such as the Netherlands is conducive to organizing a rent-seeking game, and that rents can be claimed by identifiable interest groups at the expense of the quantity and quality of health care provision in general. Such a conjecture is conceivable. Hurst *e.g.* finds in conclusion, "that health services are not an agent of income redistribution to such a degree in the U.S. as in the U.K. and Canada." (p. 120).

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CRITICAL REMARKS ON JOSEPH E. STIGLITZ: ECONOMICS OF THE PUBLIC SECTOR (3RD ED., NEW YORK: NORTON, 2000)

## 1. INTRODUCTION

Since the award of the Nobel price, Stiglitz is one of the best known economists of the world. He is the Joan Kenney Professor of Economics at Stanford University and a senior fellow at the Hoover Institute. He served as chairman of President Clinton's Council of Economic Advisors and then as chief economist of the World Bank. Before, he worked at the faculties of Yale, Princeton, Oxford, etc. Besides the theory of economic regulation, major theoretical contributions were made in the theory of market failure due to imperfect and asymmetric information. Like e.g. Akerlof and Krugman he belongs to the group of top modern economists who operate outside the neoclassical framework in portions of their work. Nevertheless, he belongs to the mainstream (also in the sense of academic success) and does not define himself as a heterodox economist (see the excellent survey by D. Colander: "The death of neoclassical economics," *Journal of the History of Economic Thought*, 22, 2000, pp. 127-143, especially p. 137).

His non-mainstream leanings became more explicit in his later publication *Globalization and its discontents* (New York: Norton, 2002; see the critical discussion of the book by K. Basu: "Globalization and the politics of international finance: The Stiglitz verdict," *Journal of Economic Literature*, 41, 2003, pp. 885-899). He strongly criticizes the policy of international organizations, in particular the IMF. For Stiglitz, the economic policy of the IMF is based on a dogma of bad economics (the simple belief in a free exchange economy), ideology and partial interests. The book is used as a gold mine in the anti-globalization movement and the book itself illustrates the fact of globalization: Wherever the reviewer had a look in a shop window, Stiglitz's book was already there.

At first sight, Stiglitz's book on the public sector also seems to be the valuable reference for lectures and seminars held in the spirit of non-dogmatic, mildly heterodox economics. In the following we try to make clear why we have not chosen his book and have preferred a less well known German textbook in introductory courses at the University of Erfurt, despite the general preference for English written textbooks due to the international orientation of that university. We will not comment the entire book but concentrate on some selected topics.

## 2. A CLOSER LOOK

On the front page a lighthouse is reproduced and the reviewer spontaneously asked himself, if this signifies the superior elucidating light which the author sheds on the public sector, if it is an example for natural public goods or if it highlights Coase's empirical argument that what seems at first sight to be a public good (the lightning of a lighthouse) was in fact delivered by private institutions. Therefore, we started reading the book with ambiguous curiosity.

The first page begins with the author's copyright. It underlines how important intellectual private property rights seem to be in the world of wisdom and knowledge. "Copyright ... by Joseph E. Stiglitz, the Trustee of Edward Hannaway Stiglitz Trust, the Trustee of Julia Hannaway Stiglitz Trust and the Trustee of the Trust for the Benefit of Joseph E. Stiglitz's Children". So many trust interests seem to be involved here that the reviewer personally loses some trust in the intellectual purity of Stiglitz's motives. Was the author's intention to write a bestseller and sell his name as a trademark or did he want to deliver a scientific introduction or can he do both at once?

In the preface the author first puts himself in the limelight (member of the President's Council, a two pages list with very important economists he talked with, etc.). An impressive compilation of all foreign editions comes next. It may be mentioned that the German translation and revision of the second American edition by B. Schönfelder (*Finanzwissenschaft*, Munich: Oldenbourg, 1989) closely follows the English version. But it contains some revisions due to e.g. the different tax systems in Germany and the US. It has minor extensions (at least compared with the third English edition), for example on Rawl's philosophy (1989, pp. 80-81). But it also entails a bunch of mistakes, e.g. with respect to the translation of key economic terms.

In the substantial part of the preface he points out: (1.) The book follows the unique perspective of a public sector economist; (2.) It is written for a low undergraduate level; (3.) It can significantly help to improve practical public policy; (4.) It seeks to find the appropriate balance between the public and private sector (complementarity); (5.) It tries to look at the world in an impartial manner; (6.) It wants to depict the unintended consequences of political action; (7.) The questions of the book will stretch from "What should be the role of the government?" (p. XIX), to "Should education be publicly provided?" (p. XX). Stiglitz holds that "a clear delineation between the analysis of the consequences of any policy and the value judgements associated with assessing the desirability of the policy" is possible and warranted (p. XX). In the following sentence he underlines the frequent uncertainty about the outcomes of certain policies. Stiglitz argues conventionally when he defines the role of the economist to cure "a lack of widespread understanding of basic economic issues" (p. XX).

He seems to believe that an economist can really answer e.g. the above mentioned question on education in a neutral manner (or others, e.g. on national

defense). His realistic remarks on frequent uncertainty on causes and effects puts into perspective his claim for objectivity. In the following, the reader sometimes has the feeling of a wishy-washy due to his on the one/on the other side undecidedness. Stiglitz does not offer a more precise account where he exactly stands in the economic policy debates. He only makes a general remark on Clinton's endeavor to "reinvent government" (p. XX), without explaining what this means (see the sparse general description on pp. 198-199; on 'reinventing prisons' see pp. 208-209). From the most abstract level he often quickly changes to the policy debates of his days.

In the brief introduction to part one some basic questions are asked, e.g. "What should the government do?" He continues, "(t)o answer these questions, we must begin by understanding what the government does today" (p. 1). The implicit inductive methodology of this statement does not orient the following exposition because in chapter one a deductive reasoning prevails (market failure approach, etc.) before chapter two describes the public sector of the US in detail. In the first chapter the fact of mixed economies in advanced western countries in general and a stronger role of the government in European countries in particular is mentioned. A history of economic thought passage follows where interventionism and laissez-faire are contrasted. "Smith argued that the economy was led, as if by an invisible hand, to produce what was desired and in the best possible way" (p. 6). We have shown elsewhere that this statement does not correctly describe Smith's viewpoint (H. Peukert: "Adam Smith's invisible hand", *Festschrift für G. Meijer*, ed. J. Backhaus, in print).

Stiglitz may argue that the book is only an elementary introduction, but this modest aim notwithstanding, he does no service to the reader in wrongly summarizing Smith who mentions about 80 cases for necessary interventions, including the fixing of the interest rate at a low level. A large part of *The Wealth of Nations*, book five "Of the revenue of the sovereign or commonwealth", is dedicated to the state and its activities. Stiglitz's summary, "(t)here is now widespread agreement that markets and private enterprises are at the heart of a successful economy, but that government plays an important role as a complement to the market", is a rather conservative statement and close to the laissez faire doctrine. He does not consider the market as a social institution but as a more or less automatic independent mechanism upon which the state intervenes. He repeats the image of a core (the market) and an intervening agent from outside (periphery), the state.

If two things are really complementary this distinction does not make sense and he seems to pay tribute to the conservative-liberal stance of American mainstream economists and the public opinion. In fact, modern markets like the stock exchange are themselves the result of an instituted process, i.e. laws, customs, etc. The best example is the US in which after the Civil War the government played a major developmental role and – contrary to the liberal image – applied a tough protectionist economic policy with e.g. high tariffs for

imports. These historical facts are excluded from Stiglitz stylized descriptions which contradict the underlying liberal-conservative ideology of the book. Stiglitz's setting the stage also contradicts somewhat his own insights not only in his recent critique of the IMF (see below) but also his older criticism of the big bang transition strategies in former socialist countries (see his book *Whither socialism?*, 4<sup>th</sup> print., Cambridge [Mass.]: MIT Press, 1997), where the establishment of markets was at the heart of the reform policies and the accompanying institutions came next.

The author continues to briefly describe the changing attitudes vis-à-vis the government (the Great Depression, Keynes, Johnson's war on poverty, etc.). In our view, these historical underpinnings are worthwhile, but the author only concentrates on the American example. It would be much more interesting to write a really comparative and internationally oriented book, including e.g. Canada, Europe etc. so that the horizon of students is really enlarged. Further, the methodological or theoretical status of historical facts is not clear: Do we gain major insights by history or not, does he follow an inductive or a deductive methodology. More general: Does the public economist have a special theoretical toolbox or not?

In Stiglitz's description state interventions lead to a catastrophe, the farm programs, the fight against homelessness and poverty, all failed more or less (p. 8). In his important introduction in which the theoretical field of the following is elaborated the author argues only *ex negativo*: Because the state mostly failed, if action is considered necessary, "greater care must be taken in the appropriate design of government programs" (p. 8). It is hard to believe that the state always did wrong in the history of the US. It is surprising that the public sector is introduced with an array of examples where it failed. Why didn't Stiglitz introduce the public sector with a positive example and deduce from this the importance of appropriate design? Why doesn't he mention that markets themselves are created and structured by hundreds of laws which all have e.g. impacts on distribution (e.g. labor legislation, accounting rules for firms, etc.). These orienting rules are therefore not neutral and should not be taken for granted. The superficial distinction between the market and the state stipulates a neutral operation of the laws of the market into which the state politically interferes and distorts the distributive process by taxation and welfare programs. His first more detailed example (in blue color, pp. 8-9) is the absolute failure of rent control in New York.

He lists four reasons of government failure before the concept of market failures shows up in the textbook: limited information, limited control over private market responses, limited control over bureaucracy, limitations imposed by political processes. The section concludes with Friedman's dictum "that the government should be restrained from attempting to remedy alleged or demonstrable deficiencies in markets" (p. 10). So the book starts with a negative bias against the public sector. This may correspond to the American mind in the years 1999/2000 but in a textbook it provokes the impression

that the author follows an opportunist ideology. In usual micro textbooks for example the exposition starts with a simple supply and demand schedule with the clearing of the market and the equilibrium price. In an ideal type fashion first the efficiency and positive performance is highlighted and then the specifications (conditions for a Pareto optimum, etc.) follow. Why has an inverse strategy been chosen for the public sector?

In our view it is absolutely in order to write a book with a framing assumption, for example that the state should be reduced to a certain minimum if theoretical reasons and the underlying assumptions, for example a public choice approach, are presented (see for example the refreshing open-mindedness in C. B. Blankart: *Öffentliche Finanzen in der Demokratie*, 4<sup>th</sup> ed., Munich: Vahlen, 2001). But Stiglitz only presents some descriptive empirical facts and hums and haws before he simply sets his final conclusions. He concedes that the market is efficient only under fairly restrictive assumptions but he concludes that “the recognition of the limitations of government implies that government should direct its energies only at those areas in which market failures are most significant *and* where there is evidence that government intervention can make a significant difference. Among American economists today, the dominant [and his own] view is that *limited* government intervention could alleviate (but not solve) the worst problems” (p. 10).

This is compatible with the concept of a minimal state à la Noszick (restriction to the most obvious failures, intervention must make a significant difference, etc.). His claim to achieve a balance between the public and the private sector is a misnomer, his motto in fact is ‘the most market and the least state as possible.’ So Stiglitz does not favor a really complementary view nor does he follow e.g. a historical methodology or a case to case view (the mixture always depends on the circumstances).

He does not reinvent government but adopts to the ideological position (minimize the government) which is quickly forgotten in economic policy when it comes to practical policy (see e.g. the recent conservative-liberal support for Bush’s protectionist and interventionist policies). The wishy-washy aspect consists e.g. in the fact that in his catalogue on the function of the state we also find “maintaining full employment” (p. 10). With an accompanying Nairu argument this obvious contradiction can surely be solved. Up till now, the student only knows Stiglitz’s mainstream preference. What else has he learned? Maybe that a public economist deals with his subject in a somewhat fuzzy way.

His four government failures can almost equally be applied to market processes: Limited or ambiguous information (and accompanying herd behavior) e.g. in financial markets, limited control over the bureaucracy in multinational corporations, and the fact that “representatives have incentives to act for the benefit of special interest groups” (p. 10), e.g. the Enron management. It can be argued that we face similar problems in markets and in the public



sphere. Either the author can show theoretically that these problems are in principle more pending in the public sphere or he must use a case to case method, i.e. depending on the problem at hand and the special circumstances a decision pro market or state must be made or he can argue that most important are the design problems to improve an institution's efficiency, be it the state or the market. The strong pro market bias has no theoretical foundation in Stiglitz's book.

In the following, he proclaims the emergence of a new consensus, highlighted by the initiatives of deregulation and privatization. Again the author is arguing from the political economic situation when the book was written. He also makes some advertising: "The Clinton administration sought a balance ..." (p. 11). Only at the end of the paragraph the author pretends to give a balanced picture, discussing the extreme case of the privatization of enriching uranium. "To many, this privatization appeared to be a case of the ideology of privatization gone amok – government had lost the sense of balance between the private and public sector required to make a mixed economy work" (p. 13). At the end, the author does not give any further hint how the balance should look like in principle.

On three pages the question what or who is the government is described in a very general, brief and unoriginal way (elections, certain rights of compulsion, etc.). The following part on thinking like a public sector economist starts with the orthodox description of the production possibilities schedule and the four questions: what, how etc. is produced (pp. 14-16). The introductory statement, that economists study scarcity is far from evident because in the formal definition it buys the view of the non-satiability of wants. Alternative definitions like Polanyi's "collective satisfaction of material needs" are not mentioned (see K. Polanyi: *The livelihood of man*, New York: Academic Press, 1977).

The author thinks about the public sector in terms of consumer good markets when he states, "just as some individuals like chocolate ice cream and some like vanilla ice cream, some individuals get greater enjoyment out of public parks than do others" (p. 15). Aspects like fairness do not play a role or make a difference, only consumption goods in the narrow sense seem to interest Stiglitz's citizens. The author does not know the concept of a public ethos of public servants, he supports the public choice view that different policies are good for different people, a common good for society does not exist (p. 16). This is a very dismal picture for a public sector economist. But Stiglitz does not believe this 'interest only' stylization. In flat contradiction he plays the role of the distinguished intellectual scientist in his book on globalization (mentioned above) who argues from a common interest standpoint beyond and against ideologies and partial interests.

Maybe his textbook reflects the degeneration of the American public spirit (see R.D. Putnam: *Bowling Alone*, New York: Simon and Schuster, 2001). A

formal four stage decision model (describing, analyzing, evaluating, interpreting) and an apologia of model building follows. The only substantial point is that economists should always emphasize the importance of economic incentives (p. 18). Further in a rather traditional way the author makes the distinction between normative and positive economics. The author puts it in a cost-benefit framework. His example with the tax on beer and the insight that the increase in the beer price reduces car accidents is nice but the author nevertheless falls into the objectivity trap because it depends on our subjective evaluations e.g. what should be considered as cost (only car accidents, or also family problems, etc.).

It is also surprising to read that Buchanan “has focused on *describing* the impact of political processes on social choices” (p. 20). Buchanan would not have won the Nobel price if he had only neutrally described and had not presented a very specific interpretation of political processes. In contrast, Musgrave’s three branches (allocation, stabilization and distribution) are mentioned but Stiglitz does not discuss and criticize openly his approach of a public economist in a democratic society. Again he chooses the formal defense line that the three branches cannot be compartmentalized but are intertwined, a fact that Musgrave would never have doubted. Instead, Musgrave have reproached to Stiglitz’s book that he subjects the three autonomous functions of the public sector to the problem of allocation. The first chapter ends with a hint at the disagreements among economists over values and the insight in alleged trade-offs between efficiency and equality, employment and inflation. But the author claims that a clear distinctive line between normative and positive can be drawn and that he is able to describe the major views of these debates in a detached way (p. 22).

The second chapter offers a mere description of the public sector in the US plus his skeptical bias against the state. The chapter starts with eight lines on those who opine that the public sector is too large. References of Friedman and Nozick are given. Two lines follow with the remark that the opposite opinion exists as well, this time without a reference. The author distinguishes four types of government activity (production, regulation, purchase, and redistribution) and describes different types of taxes, etc. He briefly underlines the importance of the provision of a legal system. Unfortunately this part is absolutely unconnected to the other chapters, especially to chapters one and three, where the markets are framed as more or less automatic mechanisms. The methodological problem is that Stiglitz chooses the simplified neoclassical model but that for a public sector economist maybe the institutionalist perspective is more adequate.

For example, J. Commons (see his *The legal foundations of capitalism*, Madison: University of Wisconsin, 1968 [1924]) sought to develop a realistic analysis of economic interactions based on empirical observation, a historical and evolutionary understanding and anthropological and sociological insights. He used a fivefold concept of market transactions including a sovereign author-

ity, future considerations, material scarcity, efficiency and working rules (laws and customs). But Stiglitz prefers to use the traditional neoclassical framework as the core element. His description is almost exclusively concentrated on the US. The most important trends are pointed out (growing influence of the public sector, most importantly social insurance, income tax as the principal source, dwindling of corporate taxes). But the chapter is written without any intellectual zeal or an original organizing principle.

The first 50 pages of the book offer the preference of the author, i.e. his skepticism vis-à-vis the state, and some historical and empirical data. The reader has not got much bread to become an elucidated public economist. With great expectations he starts reading part two. But the second part begins with the traditional fundamentals of welfare economics, completely uncoupled to the previous descriptive chapter. In the introduction he argues that if the markets were efficient, there would only be a very limited role for government (p. 53). This can be doubted: people may prefer a non-market nexus even if markets work well. People may want spheres in their live world in which the cash nexus does not play the organizing role. With this introduction in part two Stiglitz testifies his market fundamentalism. He starts with Smith's metaphor of the invisible hand. Again in a very simplistic way he states that Smith argued that the pursuit of private interest fosters the public interest. We cannot delve into the Smith debate here but we will only mention the fact that the sentence which Stiglitz quotes on page 56 begins with the words "(b)y preferring the support of domestic to that of foreign industry, he intends only his own security." Playfully, Smith picks up arguments of the mercantilists (for a full exposition of the context see our article on Smith's invisible hand mentioned above).

The following combination of mercantilism and the establishment of colonies is far besides the point (for the core ideas of mercantilism see H. Peukert: "Mercantilism", *Major European economists*, ed. J. Backhaus, in print). It is annoying to read that "Smith argued that it was not necessary to rely on government or on any moral sentiments to do good. The public interest, he maintained, is served when each individual simply does what is in his own self-interest" (p. 56). This statement is flatly contradicted by Smith's long chapter on the state. The infusion of public economists with such a history of economic thought nonsense background does not qualify the book. His conclusion that there "is widespread consensus among economists that competitive forces do lead to a high degree of efficiency" (p. 57) is contradicted by his own view of international financial markets in which psychology and volatile herd behavior plays a major disturbing role (see below) and his research on information asymmetries (see e.g. J. E. Stiglitz and A. Weiss: "Credit rationing in markets with imperfect information", *American Economic Review*, 71, 1981, pp. 393-410).

After this caricature of the history of economic thought and the alleged consensus he continues with the exposition of the concept of welfare economics

and Pareto efficiency. Traditional micro follows, or better: a superficial version of it. For the beginner it is impossible to understand the two theorems because they are not theoretically developed but only stated (p. 60). In the preface to part two he underlines that only under specific idealized conditions a competitive economy is efficient. In chapter three he mentions some restrictions (e.g. full information, p. 61) but he evades a discussion of the full list. “The first theorem tells us that if the economy is competitive (and satisfies certain other conditions), it is Pareto efficient” (p. 60). In footnote two on page 61 we read that “(t)here are also a number of technical assumptions.” That’s all.

Stiglitz does not and cannot fully specify all necessary conditions because it would become evident that in reality markets which fulfill the Pareto conditions do not exist. Stiglitz uses the heuristic tool of microeconomics to justify an economic policy prejudice. When he states that the second fundamental theorem “thus provides a major justification for reliance on the market mechanism” (p. 61) he commits what A. N. Whitehead called the ‘fallacy of misplaced concreteness’. This is simply bad economics. Further, Stiglitz does not explain to the reader how the statements that indifference curves are not cardinal measures and that in problem seven (p. 75) indifference curves with cardinal numbers show up can be reconciled. We will leave it to the reader to evaluate if our public economics student has now got a clearer understanding of his role after page 75 and the rudimentary knowledge of Pareto efficiency.

Chapter four deals with market failure. Stiglitz first points out that property rights and contracts must be enforced. “In some societies, land is held in common; anyone can graze their cattle and sheep on it. Since no one has the property right to the land, no one has an incentive to ensure that there is no overgrazing” (p. 77). He repeats the story of the tragedy of the commons. Private property is offered as the only reasonable alternative. Unfortunately, he does not mention that for thousands of years socially shared norms controlled and regulated overgrazing successfully (see E. Ostrom: *Governing the commons*, Cambridge: Cambridge University Press, 2002). He seems to believe that the problem can only be solved with markets and private property because then “the benefits of such improvements are reflected in the market price of the property” (p. 77). It is surprising that the chapter on market failure gives the market three cheers at the beginning. He then comes to the classical cases of imperfect competition and public goods, his prime example is national defense.

Interestingly lighthouses are mentioned as examples for pure public goods (non-rivalry and almost non-excludability, see also page 128). Stiglitz does not recognize the historical-empirical examples of Coase that lighthouses could and were run by private institutions. This example highlights the problem that it is almost impossible to define a public good by its alleged intrinsic characteristics. Even for defense a (semi-)private solution is not totally unrealistic. In addition, he describes incomplete markets (insurance and capital

markets in particular), externalities, information failures (very poorly described on page 82), and finally unemployment and inflation as examples for macroeconomic disturbances. Unfortunately, Stiglitz does not tell the reader how markets work in general in the real world (we only have the unrealistic neoclassical model in chapter three). So the reader does not know how important the failures are (in his view). At the end of the chapter, he discusses income distribution and merit goods. The chapter as a whole seems to be written by a different author (compare page XXIII) compared with the previous ones because the anti-public bias is missing.

The conclusion of the chapter is that if markets are imperfect and do not lead to a Pareto optimal result, the state should intervene. But he adds two qualifications. "First, it has to be shown that there is, at least in principle, some way of intervening in the market to make someone better off without making anyone worse off, that is, making a *Pareto improvement*" (p. 89). This is a surprising remark, first because it implies that we can really measure the utility of all economic agents involved, again we see the problem of misplaced concreteness lurking in the background. Second, it is almost logically impossible that no one is worse off in cases of remedying market failures: The monopolist loses his monopoly rent, the producer loses profit when he has to pay for the externality he produces, etc.

Stiglitz's argument leads the market failure-public function approach into absurdity. So at the end he comes back to his anti-public attitude and finishes the chapter with the remark that often programs justified in terms of market failure are simply rhetoric (p. 90). But the opposite may also be true: So many arguments (Pareto principle, bureaucracy, information costs, etc, which are scattered on pages 87-90) can be piled up that together they serve to legitimize a do-nothing attitude in the face of obviously dysfunctional market or anti-market (monopoly) processes. At the end the author once again does not hold the alleged balance.

Chapter five tackles the delicate problem of efficiency and equity. For Stiglitz there is no doubt at all that there "is a **trade-off** between efficiency ... and equity" (p. 94). He does not give any reason for this stipulation and puts it in an all or nothing context: oranges are taken from Robinson and given to Friday but some oranges will be lost due to this distributive procedure. He does not put the general argument in a realistic economic context of present-day societies. Instead he constructs a diagram with utilities, possibility curves, and social indifference curves signifying social preferences for utilities of Robinson and Friday. His elaboration boils down to a rudimentary introduction into the concepts of marginal utility, etc. With the objectively neutral looking concept of decreasing marginal utility he derives formally that transfers are costly. But he also smuggles in the most primitive and conservative argument against redistribution which is at least very helpful for people on the sunny side of society.

It must be underlined that Stiglitz presents the following argument without any qualification; it is the only substantial remark beyond the abstract Robinson-Friday curves. “Social welfare functions can be thought of as a tool economists use to summarize assumptions about society’s attitudes toward different distributions of income and welfare” (p. 99). They are presented as realist tools for empirical decisions of the public economist. There is no doubt, that something like figure 5.5 (a social indifference curve with combinations of different group utilities among which society is indifferent), has never been constructed by a serious economist with the claim to depict something in the real world.

“In our society, the way we transfer resources from one group (say, the rich) to another (say the poor) is by taxing the rich and subsidizing the poor” (p. 98). This is the method with the slash-hammer. A public economist should know that e.g. labor legislation, zoning laws etc. also influences distribution. He continues: “The way we do that normally interferes with economic efficiency. The rich may work less hard than they would otherwise, because they reap only a fraction of the returns to their effort; while the poor may work less hard because by working harder, they may lose eligibility for benefits” (p. 98). Complex societal and economic problems are reduced to a primitive utilitarian laymen psychology. No hint is given to e.g. the discussion of the Asian miracle where the argument plays a role that greater equality is good for economic development and that great inequality reduces the developmental prospectus of countries (this is at least a main argument in chapter four in Stiglitz 2002). But the major aim of the book seems to be to infuse young economists with the ideology of the great trade-off and the explicit message that the state should better not intervene and the public sector be minimized.

Next, a primitive version of utilitarianism and Rawls’ position are contrasted. It is not to ask for misplaced sophistication in a textbook when we mention that it is pure nonsense to summarize Rawls argument with the following words: “(S)ociety is better off if you improve the his [the worst-off individual’s] welfare but gains nothing from improving the welfare of others. There is, in his view, no trade-off” (p. 102). Surprisingly, the author adds some caveats. Stiglitz notes that in this chapter the assumption is made that we can compare levels of utility of groups or individuals cardinally, but that “many economists believe this interpersonal comparisons cannot be made in any meaningful way” (p. 103).

After having learned the exercise of defining utility possibility curves, individual and social indifference curves, budget constraints, and finally admiring the tangency between social indifference and utility possibilities curves, the exhausted reader is informed that “(u)nfortunately ... few policy changes are Pareto improvements, and hence without making interpersonal comparisons of welfare, economists have little to say regarding policy” (p. 104). This is the admonition that all the curve drawing is good for almost nothing and a well-

intentioned young student will be disappointed. But maybe this is the silent lesson: Reduce your good intentions and your aspiration level, do not believe in the common good and that something can be changed, take a know- and (almost) do-nothing attitude and understand that this exercise is not *Economics of the Public Sector* but *Economics against the public sector*. For Stiglitz, society does not even exist. In a Thatcherite manner he explains: "Society consists of many individuals; but society itself does not have preferences" (p. 104).

In the rest of the chapter the author presents a wild mixture of realism and theoretical opportunism. He first states that "(i)n practice, government officials do not derive utility possibilities schedules, nor do they write down social welfare functions" (p. 104). But then he continues that they first try to measure the net benefits and second try to find out if it is a Pareto improvement or not. "*Efficiency* is measured by simply summing the gains or losses for each individual ... *Equity* is measured by looking at some overall measure of inequality in society" (p. 105). So statistics is the solution and willingness to pay studies are the tool to measure benefits. In a complicated way he explains with numerical examples how a (compensated) demand curve can be derived. He does not give one sentence to the fact that it is almost impossible to realistically draw a compensated demand curve based on willing to pay inquiries not to mention the preference camouflage, which is highlighted in chapter six where he discusses the free rider problem, i.e. the incentive not to reveal the full value of a good or service (p. 135). "Even if individuals were asked directly what their preferences are, would they truthfully and meaningfully reveal them?" (p. 157). Good question! In addition, he does not mention the framing effects of the respective inquiries. Equity can be measured (e.g. by a poverty index) but how shall we compare it numerically with efficiency, if we accept the alleged trade-off?

This problem is hinted at in the last sentences under the rubric of the use of weights. Three assumptions are mentioned which are helpful for weighting: diminishing marginal utility (the layman psychologist's principle which is correctly put into question, see G. Becker *et al.*), different individuals have the same relation between utility and income (a strong assumption), and society is concerned with total utility (but why should society buy this unsophisticated utilitarian philosophy?). The last sentence of the chapter leaves the student with a question mark. "While each of these assumptions may be questioned, we can think of these procedures as simply a convenient way to summarize data that decision makers often find helpful" (p. 117). It is not clear what the author wants to say: how can assumptions be a convenient way to summarize data? With this final nonsense sentence the author admits that we are facing sad remains.

Part three deals with public expenditure theory. Chapter six distinguishes public and private goods in the usual way. Three methods of rationing publicly provided goods (user charges, uniform provision and queuing) are described

with their advantages and disadvantages in an objective way. Unfortunately, a part on efficiency conditions for public goods follows, collective demand curves are derived and the optimality conditions are describes in detail. "Pure public goods are efficiently supplied when the sum of the marginal rates of substitution (over all individuals) is equal to the marginal rate of transformation" (p. 141, in italics). At least in one instance the author points out that efficiency considerations and questions of distribution cannot be separated. "(O)ne cannot separate out efficiency considerations in the supply of public goods from distributional considerations. Any change in the distribution of income, say, brought about by a change in the income tax structure, will thus be accompanied by corresponding changes in the efficient levels of public-goods production" (p. 147).

This is a correct insight which might have been taken into consideration in the chapter on efficiency and equity. The chapter ends with the recognition of an efficient government as a public good but in a few lines only trivialities are presented. "If the government is able to become more efficient and reduce taxes without reducing the level of government services, everyone benefits" (p. 149). Is this all what a public economist has to say?

Chapter seven repeats the well-know arsenal of public choice. First without any caveat the glory of the market is highlighted. "Indeed, one of the central results of modern welfare economics, as we pointed out in Chapter 3, is that in a competitive economy, the resulting resource allocations are efficient. Decisions about resource allocations in the public sector are made in quite a different manner ... there is no comparable effective way that individuals can express their views about the desirability of one public good versus another" (p. 157). By and large the following analysis is a deficiency analysis of the public sector. It does not come to the author's mind that there may exist a different logic for vanilla and e.g. the decision making process of the educational system. In one sentence it is noted that votes are intended to represent the interests of the constituents. Then a great fuss is made on the voting paradox and some pages are filled Arrow's impossibility theorem. The author does not ask if it is very important in reality (in G. Tullock's opinion the answer is no) and his explanation of the property of single-peakedness is not very easy to follow for a freshman (pp. 166-167).

The author does not discuss the proposals to limit or prevent the voting paradox. Instead he underlines Buchanan's view of the self-interested individuals, Lindahl's approach (and the problem of revealing preferences), and a rather unimaginative diagram on Lindahl's solution (for a better exposition see e.g. D. Brümmerhoff: *Finanzwissenschaft*, 8<sup>th</sup> ed., Munich: Oldenbourg, 2001, p. 127). The final conclusion is that "it appears that there is no perfect solution to the problem of collective decision-making in democratic societies" (p. 177). The end result of each chapter seems to be that the only thing a public economist learns is that no practical conclusions can be drawn when the tra-



ditional neoclassical economic tools (which may be adequate for the analysis of market processes) are used to analyze the public sector.

The author also briefly mentions the paradox that people vote at all. His only explanation is educational manipulation (“considerable time and energy are devoted to inculcating into our children notions of civic responsibility,” p. 178), i.e. again an ad hoc psychological layman explanation. But he suddenly comes back to the main track, now focusing on the power of special interest groups. He is a dismal negativist who cannot imagine more altruistically oriented politicians or mechanisms which favor a somewhat altruistic behavior, well-knowing that “(e)ffective government depends on the quality of these public servants” (p. 179). In a blue collar comment (pp. 180-181) he doubts that social reforms to limit the amount of money that any organization can give to candidates or political parties can be successful. So the chapter once again ends with the message of economics against the public sector.

Under the heading “Public production and bureaucracy” chapter eight is concerned with the role of government in production, e.g. in the case of a natural monopoly. He also discusses alternatives (regulation and taxation) and the Demsetz/Stigler view to leave private monopolies for themselves. Again a major emphasis of the chapter is put on government inefficiencies. He hints at “shocking stories of government inefficiencies” (p. 198), and claims that “comparisons of costs of government and private firms engaged in similar activities tend to show substantially lower costs for private firms, whether in housing, garbage collection, bus transportation, ...” (p. 198). This statement is a somewhat incorrect extrapolation of the non-evident record of the data. Consequently, one page later he states, “some evidence shows that this need not be the case” (p. 199). The student reader will be a little bit perplexed.

In brackets he still mentions that eventually other components of public procurement are not or cannot measured in price comparisons, e.g. citizenship values. But the sources of inefficiency are identified in soft budget constraints (public enterprises not driven by the profit motive), civil service rules (high pay for good civil servants and job security), procurement and budgeting restrictions, and bureaucratic behavior (e.g. risk aversion). Unfortunately, the author does not really show why this is necessarily so in the public sector and in how far a difference between public and private corporations exists. He mentions in passing that the principal-agent problem of controlling managers also exists in private firms (p. 203) but this does not at all influence the main thrust of his reasoning. The chapter ends with the description of a growing consensus on the government’s role in production. But the only sure points seem to be that the government should not be engaged in the production of private goods, that private firms should have an extended role in production, and that the government is in any case responsible for defense. “To what extent can government, by imitating the private sector - for instance, by making more extensive use of incentive pay - achieve comparable efficiencies?” (p. 209). It may be asked if the private sector and its logic should really be

the only benchmark and ideal model for the public sector. Cannot the public sector find its own way of empowerment instead of copying the private sector (see R. Frank: *Choosing the right pond*, New York: Oxford University Press, 1986) and can't the public servants be motivated in a less self-interested way (see A. Etzioni: *The moral dimension*, New York: Free Press, 1988).

The reader is again left alone with a bunch of open questions. "Should prisons, welfare agencies, schools, or the production of the material to make nuclear bombs be privatized?" (p. 211). A rereading of the book after 9/11 shows how strongly the short-period *zeitgeist* rules the roost (in the quote especially the remark on the nuclear bombs!) when he finally states that the locus of controversy refers to services once thought to be part of the central provenance of government. The renationalization of services like the control at airports shows the changing emphasis.

Chapter nine deals with externalities and the environment. The text describes the problems and the solutions, e.g. fines and taxes, subsidies and marketable permits etc., in a non-biased way. Sometimes, the reader is left in the air, e.g. when the Coase theorem is described and the text continues that of course "the determination of who compensates whom makes a great deal of difference to the distributive implications of the externality" (p. 219). So, is the theorem finally correct or wrong? The interested reader gets no answer. Also the defense of the rejection to ratify the Kyoto protocol (unwillingness of the developing countries) by the US Congress can irritate the reader.

Instead of discussing chapter by chapter, in the following we will only highlight some points and then draw final conclusions. Chapter eleven presents the cost-benefit-analysis. The author mentions that e.g. the value of a human being varies in these analyses between 1 and 20 million dollar. It can be asked if e.g. the 'constructive method:' "What would the individual have earned had she remained alive?" (p. 280) is in conformity with human rights and the German Constitution. Also the strong disagreements on the concrete value of the discount rate (the differences are summarized on page 288) casts strong doubts on the alleged scientific objectivity of this procedure.

Chapter 13 on defense and technology has strong apologetic underpinnings. It justifies scientifically the American policy in the past arms race. "Game theory was used ... as the basis of the theory of deterrence, which underlay American defense strategy" (p. 335). Figure 13.2 applies the would-be precision of marginal analysis to the number of missiles. "The relevant question is ... how many extra kills we get from each additional missile. There may be sharply diminishing returns" (p. 334). Like other American textbooks, in the defense business a more is better philosophy prevails (with the typical Stiglitz caveats, see pages 337 and 775) in contrast to the curtailment arguments when the social question is dealt with. The author also supports the theory of the two-theater capability which easily can be enlarged to a multi-theater argument. "(P)otential enemies or troublemakers may wait until the United States

is occupied with fighting in one theatre [a minimizing newspeech word] to start trouble in another” (p. 336). Is it funny or tragic to read that “even if Iraq had not engaged in biological warfare, the numerous maladies plaguing those returning from the Gulf War were a constant reminder of the threat of chemical weapons” (p. 338)? The description of the American attitude with respect to arms control agreements (pp. 337-338) is lamentable fairy tale (compare the irritating opposite view in e.g. Stiglitz’s article *Bush braucht Widerstand* [Bush needs resistance] in *Süddeutsche Zeitung*, 29.09.2003, p. 2; for the historical facts see Ch. Johnson: *Blowback*, London: Time Warner, 2002).

The chapter on social insurance is descriptively interesting but one-sided. In the part on reforms only investing trust funds in equities and privatization are mentioned (pp. 377-378). The alternative of a broadening of the basis of those who have to pay into the social security system as it exists in the Switzerland is not mentioned at all (compare the recent debate in Germany on an encompassing citizen insurance). In the chapter on welfare programs a strong emphasis is put on distortions and with the typical Stiglitz relativity remark at the end (pp. 413-414).

The large part five deals with taxes. It has a remarkable slip of the tongue. “Such forced transfers have been likened to theft, with one major difference: Transfers through the government wear the mantle of legality and respectability conferred upon them by the political process. When the political process in a country becomes detached from the citizenry and is used to transfer resources to the groups in power [a probable fact, especially according to chapter seven], the distinction between taxation and theft becomes blurred at best” (pp. 451-452). This is a peculiar way to introduce taxes in a textbook.

The underlying assumption in his discussion of taxes is that in “competitive markets, firms produce at the level where price equals marginal costs” (p. 484). The author does not discuss for a second in how far this assumption holds in the real economic world. We agree with Stiglitz II who underlines: “Economic policy must be predicated not on an ideal world but on the world as it is. Politics must be designed not for how they might be implemented in an ideal world but for how they will be implemented in the world in which we live” (2002, p. 194). But maybe the negative message is the more important point here: the student learns to deduce from diagram 18.1 that a tax reduces output and increases prices (p. 485). Somewhere in the chapter on tax incidence in a brief paragraph the fact of oligopolies is mentioned: “There is no widely accepted theory of firm behavior in oligopoly, and so it is impossible to make any definite predictions about the incidence of taxation in this case” (p. 501). Full stop, and here he goes and continues with partial equilibrium analysis. If reality does not allow easy conclusions, it deserves to be disregarded.

In chapter 19 taxation and economic efficiency and in chapter 20 optimal taxation are discussed. The author does not mention that the deadweight loss

philosophy in these chapters depends on the assumption of fully competitive markets, firms as price takers, etc. The text does not convey the honest spirit of optimal taxation theorists who never forget to mention their limited relevance for practical economic policy. In the following, Stiglitz tries to support the view “that interest income should be exempt from taxation ... *Whatever the government could do with a distortionary tax on producers, it could do better with a direct tax on consumers that maintained the economy on the production possibilities schedule*” (pp. 567 and 569).

In chapter 21 he argues against the taxation of capital. To be able to do so, he constructs a “simple economy in which individuals own their own firm, investing their savings in capital, facing decisions on how much to save and invest” (p. 578). Without taking into account repercussions and restricting himself to the level of a single business firm (fallacy of composition?) it is almost tautological to show that a tax on capital is bad for investment. “In a closed economy, in equilibrium savings must equal investment. Thus, *in equilibrium* a policy which promotes savings must promote investment, and conversely” (p. 583). If the real economy ever was in a partial or total equilibrium does not seem to be an important question. The message counts: Don’t tax the rich! He enumerates all important arguments for a consumption-based tax (pp. 579ff.), but he does not even mention one argument against it, e.g. that a neutral consumption tax must have a tax percentage increase of 25 per cent or more. Does Stiglitz assume that his self-interested economic agents will not have a strong incentive to circumvent the high final consumer prices and choose black market solutions?

Finally, in a pre-scientific way he tells the student that “(b)y borrowing, the government places the burden of reduced consumption on future generations” (p. 783). Counter arguments are wiped away in few sentences, they have no scientific validity. That the underutilization of resources can be harmful and deficits can in principle stimulate the economy is mentioned on nine lines in a book with 823 pages.

### 3. CONCLUSIONS

Summarizing, we may formulate the following shortcomings of the book: (1.) It has an implicit conservative-liberal ideology without putting the normative cards explicitly on the table; (2.) The book applies the wrong methodology (formal neoclassical reasoning), and almost completely ignores sociological, historical and other aspects; (3.) The descriptive parts do not really convey framing knowledge and they are not comparative; (4.) The economic history and history of economic thought parts are more fairy tale than scientific elaborations in a nutshell; (5.) The author takes the necessary public institutions for granted which are necessary for the functioning of the private sector (antitrust policy, third party enforcement of contracts, etc.), he only mentions them peripherally, the market is construed as an objective, automatic mecha-

nism into which the state interferes; (6.) Very often the diagrams are not well explained; (7.) The student has no applicable tool-box for decisions of the real world in the public sector at hand; (8.) The author shifts between the assumption that the neoclassical tool-box can be applied and the opposite view that this is not possible; (9.) The author has in fact written a book *Economics against the public sector* because a positive normative vision of the productive role of the state is missing; (10.) If we take into consideration his recent publications we have get a somewhat schizophrenic impression of a Stiglitz I (his textbook) and a critical Stiglitz II.

Stiglitz II castigates the Washington consensus and “market fundamentalist policies” (2002, p. 106), decisions should not be made “on the basis of what seemed a curious blend of ideology and bad economics, dogma that sometimes seemed to be thinly veiling special interests” (2002, p. 12). His reproach is that „(f)iscal austerity, privatization, and market liberalization were the three [only] pillars of Washington Consensus advice“ (2002, p. 53). The same holds to a certain degree, besides the descriptive parts, for his textbook which is in most parts „based on a simplistic model of the market economy, the competitive equilibrium model in which Adam Smith’s invisible hand works, and works perfectly” (2002, p. 74). Stiglitz II calls this attitude ‘market fundamentalism.’ Another aspect of market fundamentalism is its normative one-sidedness. “Stabilization is on the agenda; job creation is off. Taxation, and its adverse effects, are on the agenda; land reform is off“ (2002, pp. 80-81). Further, it comprises a spontaneous order theorem, the “IMF simply assumed that markets arise quickly to meet every need, when in fact, many government activities arise because markets have *failed* to provide essential services” (2002, p. 55).

In his book on globalization he underlines the positive effects of state supported firms. “While its neighbors, Singapore and Malaysia, had invited in multinational companies, South Korea had created its own enterprises. Through good products and aggressive marketing, South Korean companies had sold their goods around the world” (2002, p. 102). The closure of state enterprises “may leave a huge gap” (2002, p. 55).

Against the trickle-down hypothesis, i.e. that efficiency and growth will at the same time more or less solve the distributional problem, he now argues, “(t)rickle-down economics was never much more than just a belief, an article of faith” (2002, p. 78).

Ideal type markets like capital markets, can be unstable in principle due to the rational and irrational moods of the investors. He shares Keynes pessimism on the “often seemingly irrational changes in sentiment” (2002, p. 100).

Stiglitz should rewrite his textbook and start with a positive vision of the state and the public sector, following his own more recent intuition. The discount which must be paid to reality comes early enough. We need young students who are enthusiastic to become civil servants, who want to foster the common good and who find the dismal self-interested anti-public rhetoric boring

and wrong, young motivated public sector economists who grasp the potential of a democratic, social, environmentally sound and efficient state which gives the citizen the realistic feeling of fairness and belonging.

“Government can, and has, played an essential role not only in mitigating these market failures but also in ensuring *social justice*. Market processes may, by themselves, leave many people with too few resources to survive. In countries that have been most successful, in the United States and in East Asia, government has performed these roles and performed them, for the most part, reasonably well. Governments provided a high-quality education to all and furnished much of the infrastructure – including the institutional infrastructure, such as the legal system, which is required for markets to work effectively. They regulated the financial sector, ensuring that capital markets worked more in the way that they were supposed to - they provided a safety net for the poor. And they promoted technology, from telecommunications to agriculture to jet engines and radar. While there is a vigorous debate in the United States and elsewhere about what the *precise* role of government should be, there is broad agreement that government has a role in making any society, any economy, function efficiently- and humanely” (2000, p. 218).

ALEXANDER EBNER

# GOVERNANCE AND INSTITUTIONAL REFORM: A CRITICAL ASSESSMENT OF THE WHITE PAPER ON EUROPEAN GOVERNANCE

## 1. INTRODUCTION

Following the failure of the referenda in France and the Netherlands that should promote the ratification of the European Constitution, the current crisis of the integration project is most visible regarding ongoing conflicts on the fiscal structure of the Community budget both on the income and expenditure sides. Highlighting these aspects, the problem of financing activities in education and innovation as required by the Lisbon process is contrasted with persistent income transfers to the agrarian sector. Thus, in accounting for the dimensions of democratic participation, fiscal structures and state capacity at the same time, the matter of governance and institutional reform remains of utmost importance for the future perspective of European integration. Indeed, it is safe to argue that problems of political leadership in the European Union will rank high on the policy agenda, as indicated by the British Prime Minister's speech to the European Parliament on 23 June 2005, for he pointed to the need for combined institutional and fiscal reform in implementing the Lisbon strategy on the competitiveness of the European economy (Blair 2005).

This conflict-ridden situation, however, indicates once more the need for critically examining a decisive reform proposal of the European Commission that was issued well before the final draft of the Constitution had been taken to the fore: the White Paper on European Governance, published in 2001, which discusses major aspects of institutional reform in an Enlarged European Union (Commission 2001). It is settled in the rather provisional procedures of the Post-Nizza setting, while awaiting a constitutional consensus on the institutional foundations of European integration. Therefore, it had been discussed primarily as a statement of the Commission from the perspective of preparing the process of constitutional design. However, it is currently more adequate to account much more specifically for the actual strategic content of the White Paper. In particular, the orientation towards the notion of governance as a key concept in the Commission's proposals provides for the persistent analytical relevance of the White Paper after the failure of the ratification of the European constitution. Indeed, it refers to the continuous search for an adequate institutional matrix in support of both legitimacy and efficiency.

Understanding the conceptual implications of the notion of governance requires some elaboration. As a point of departure, public goods may be ap-

proached as multi-actor products, for various actors apart from the state are involved in coordinating their provision, in particular coming from the private business sector and civil society (Kaul 2001: 255-6). In contrast to the notion of government with its hierarchical connotations, governance addresses reflexive self-organisation and rule-based, decentral steering capacities in the policy domain. In terms of its concern with both administrative efficiency and democratic legitimacy, governance is perceived as a cooperative steering approach that should allow for participation, transparency, efficiency and responsibility, quite in accordance with rule-guided procedures that have become prominent in discussions on the reform of government and administration under the moniker of “good governance” (Grindle 1997). Thus, the notion of governance addresses the organisational conditions for reforming procedures of policy-making in government and administration on the basis of democratic principles, yet it is also concerned with the inclusion of civil society and private sector in the formulation and implementation of public policy (Kjaer 2004: 3-6).

Based on these considerations, the following sections proceed with a reconstruction of the major lines of reasoning in the Commission’s White Paper on European Governance, pointing to the implications of the notion of governance as a device for institutional reform. The presentation is arranged as follows. The first section deals with Commission’s diagnosis of the state of European governance in the situation of the Post-Nizza process of integration, addressing the prospects for institutional change and policy reform based on the principles of good governance. The second section explores the Commission’s more detailed proposals for change, in particular coping with the matter of democratic participation and the inclusion of the issue-specific networks of civil society. The third section summarises related arguments on the future course of European governance, highlighting the propositions for reorienting both policies and institutions. Finally, the fourth section seeks to evaluate the White Paper’s statements in the context of related efforts in theorising on European governance, in conclusion emphasising the persistent relevance of that topic beyond the failures in ratifying the European constitution.

## **2. EUROPEAN GOVERNANCE AS A STRATEGIC PERSPECTIVE ON INSTITUTIONAL REFORM**

The White Paper on “European Governance”, published on 25 July 2001, is presented in four chapters dealing with the reasons for a reform of the system of governance in the European Union, the principles of good governance, and distinct proposals for change that address the policy-related matter of involvement, regulation and delivery as well as the role of global governance as arguments for refocusing policies and institutions in a comprehensive reform process (Commission 2001: 2). In this context, the Commission addresses the notion of governance in agreement with established interpretations from the



discourse on reform strategies in government and administration, applied to the matter of European integration: “Governance’ means rules, processes and behaviour that affect the way in which powers are exercised at European level, particularly as regards openness, participation, accountability, effectiveness and coherence” (Commission 2001: 8).

These principles of good governance represent the conceptual core of the Commission’s reform proposals and the underlying strategic outlook on the role of the state in the process of European integration. This exposed status of the notion of good governance is also prevalent in the presentation of the key concerns of the White Paper that are presented in its Executive Summary. Right from the outset, the White Paper argues that the complexity of policy formulation and implementation in the European Union is not adequately met by the established institutional set of governance structures and processes, thus contributing to a deepening crisis of legitimacy in its citizenry. The corresponding strategic outlook is characterised as follows: “Many people are losing confidence in a poorly understood and complex system to deliver the policies that they want. The Union is often seen as remote and at the same time too intrusive. (...)The White Paper proposes opening up the policy-making process to get more people and organisations involved in shaping and delivering EU policy. It promotes greater openness, accountability and responsibility for all those involved” (Commission 2001: 3).

By explicitly addressing a comprehensive array of institutions – involving central government, regions, cities, and civil society – the White Paper underlines an argumentation that perceives governance in a multi-actor and multi-level policy context. With regard to the resulting proposals for change, then, this orientation towards an institutional setting of multi-level governance that should contain a wider sphere of interactions with civil society is accompanied by an emphasis on the need for both legislative and non-legislative instruments. This perspective on governance as an institutional process is presented in terms of a renewal of the Community method of policy-making, which implies a flexibilisation of the separation of legislative and executive powers between Commission, Council and Parliament: “The Union must renew the Community method by following a less top-down approach and complementing its policy tools more effectively with non-legislative instruments” (Commission 2001: 4).

Accordingly, the flexible correspondence of governance profiles with the institutional mechanisms of deliberative democracy is taken to the fore. In particular, this aspect of public discourse and civil society involvement in the actual terrain of policy-making is reflected by the measures that are specified in the proposals for change. They involve measures of e-Governance provided by the Commission, accompanied by measures that should support interactions with regional and local governments as well as with organisations of civil society. Recommended means are multi-level dialogues among regional, national and Community levels in the policy process, local flexibility in imple-

menting Community legislation, and the standardisation of more transparent consultation procedures, to be accompanied by improvements in the preparation of policy results through diverse policy tools, simplified legal rules, more transparent external advice, and improved mechanisms for enforcement and regulation (Commission 2001: 4-5).

Moreover, well in addition to the matter of governance in terms of an institutional reform of policy processes, the White Paper refers to the matter of global governance in combination with the notion of good governance, interpreting both as concepts for a more effective international dialogue with governmental and non-governmental actors: "The Union should seek to apply the principles of good governance to its global responsibilities. It should aim to boost the effectiveness and enforcement powers of international institutions" (Commission 2001: 5). This strategic orientation towards the international position of the EU is paralleled by a concern with refocused institutions in the division of responsibilities between Commission, Council and Parliament that should allow for increased policy coherence in accordance with established long-term objectives (Commission 2001: 6).

The latter aspect points to the projected renewal of the Community method as a key concern of the reform of the European system of governance, highlighting a separation of powers in which the European Commission makes specific legislative and policy proposals in its function as guardian of the Treaties, who represents the Community in international negotiations; whereas, fundamental legislative and budgetary acts are adopted by the Council of Ministers as representative of the Member States and the European Parliament as representative of the citizens. While the execution of policy is entrusted to the Commission and national authorities, the European Court of Justice enforces the rule of law (Commission 2001: 8).

This leads to the question of the Commission's perception of governance as a conceptual framework that should inform the reform of the institutional architecture of the European Union. According to the White Paper, the five principles of openness, participation, accountability, effectiveness and coherence are singled out as factors that underpin good governance and the changes proposed for the institutional reform of policy-making in the European Union, promoting democracy and the rule of law in the Union's setting of multi-level governance. Openness points to the matter of transparency in the formulation and communication of the various policies, paralleled by need for comprehensive participation in an inclusive mode of policy-making. Accountability then shapes the roles of EU institutions as well as national and regional governments and other participating actors in the legislative and executive processes, thus contributing both to the effectiveness of policies and the coherence of these policies and corresponding action in the complex setting of a European Union its enlargement (Commission 2001: 10).

Moreover, these principles of good governance are said to reinforce decisive policy-related principles that result from the interpretation of the Treaties, namely proportionality and subsidiarity. They highlight the choice concerning the level at which policy action is actually to be taken as well as the selection of adequate instruments. In conclusion, due to the increasing complexity of the Union's policy agenda regarding both internal and external affairs, the corresponding mode of governance is need of a systematic adaptation towards more flexibility in practice: "This means that the linear model of dispensing policies from above must be replaced by a virtuous circle, based on feedback, networks and involvement from policy creation to implementation at all levels" (Commission 2001: 11). With these concerns for civil society participation, then, the White Paper spells out specific proposals for change that need to be translated into detailed reform measures.

### **3. TOWARDS A REFOCUSED MODE OF GOVERNANCE IN THE EUROPEAN UNION**

As put forward in the Commission's White Paper, the proposals for change regarding the reform of the institutional foundations of policy-making address four distinct points: first, the problems of participation and transparency as key concerns of the governance approach; second, the policy-related aspects of regulation and delivery that pinpoint the public good quality of policy-making; third, the external dimension of the reform process with regard to the matter of global governance; fourth, the strategic orientation of policy-reform and institutional change for the institutional matrix underlying European governance. Thus, even with regard to the discursive structuration of these proposals, the substantial comprehensiveness of the notion of governance, as taken to the fore by the Commission, becomes obvious. It ranges from democratic participation and deliberation over administrative efficiency to global governance. However, while that lack of conceptual specificity may reflect the multi-faceted character of the subject under consideration, it may also promote the realisation of contradictory interpretations.

Regarding the first aspect of an improved involvement of various actors in the process of policy-making, the argumentation of the White Paper takes its point of departure in references to the indispensable role of public debate, involving access to information as a requirement for the participation in communication among actors in the general public. At this point, the Commission is primarily viewed as a provider of knowledge and moderator of knowledge networks, based on information technology in terms of e-Governance (Commission 2001: 11-2). Moreover, reflecting the knowledge-related complexity of multi-level governance, the local and regional level of democratic participation and government activity should be strengthened, paralleling national involvement under conditions of increased flexibility and coherence. This should involve an institutionalised dialogue with European and national as-

sociations of regional and local governments, including the Committee of the Regions, as well as by the experimental launching of target-based contracts in the implementation of EU policies (Commission 2001: 12-4).

In addition to that, the Commission emphasises the outstanding role of civil society in voicing citizen preferences by promoting structured feedback channels and in delivering collective goods that contribute to meeting these preferences. In this line of reasoning, then, the domain of civil society should include trade unions and employer organisations, from a neo-corporatist perspective actually denoted as social partners, who can reach binding agreements that may be turned into Community law, following the consultation mechanism of the EU platform of social dialogue. Moreover, nongovernmental organisations, professional associations, charities, grass-roots organisations, local and municipal organisations, yet also churches and religious communities are mentioned as constitutive components of civil society (Commission 2001: 14-5).

The advocacy of an inclusion of the organisations of civil society in the communication and deliberation networks of European policy making is combined with a hint at the procedural responsibilities that coincide with participatory rights. In particular, the aspects of accountability and openness are mentioned with regard to the possibility of governance failure due to the sclerosis of exclusive networks. As in the case of participatory strategies, technological means of e-Governance are outlined as levers of institutional change, in this case through supplying databases that should assist in the reorientation of the internal structures of civil society organisations towards the principles of good governance (Commission 2001: 14-5). Moreover, the Economic and Social Committee is singled out as an institutional actor that should facilitate corresponding patterns of responsibility – while it is implicitly portrayed as an arena for producer-related interest groups. Indeed, the order of listing the various participants of that Committee speaks for itself, as the White Paper enumerates: “representatives of producers, farmers, carriers, workers, dealers, craftsmen, professional occupations, consumers and the general interest” (Commission 2001: 15). Evidently, the potential tension between the interests of both the latter groups and all of the former is not considered to be relevant for further scrutiny.

In agreement with these considerations, the Commission takes up the matter of consultation as a feature of policy deliberation. Beyond the confines of democratic dialogue with civil society organisations, the use of expert knowledge is taken to the fore as a major issue, which is also of concern for the European Parliament and its committees. At this point, the institutional advantage of a “reinforced culture of consultation and dialogue” is highlighted (Commission 2001: 16). Yet the lack of transparency and openness that is potentially related with these network-based modes of European policy making is said to require counter-measures like public reviews of consultative procedures, accompanied by a code of conduct with minimum consultation

standards that could even prepare the ground for partnership agreements between the Commission and civil society organisations, combining reform efforts in external and internal governance dimensions (Commission of the European Communities 2001: 16-7). All of this points to the impact of issue-related networks in the domain of European policy making, which need to become more accessible for the general public (Commission 2001: 18).

The second line of reasoning that is associated with the White Paper's proposals for change highlights the need for improving the implementation of policies, that is, the corresponding modes of regulation and their actual delivery. The underlying argument suggests that EU policies and legislation are getting increasingly complex, thus slowing down the legislative process. Accordingly, policy execution by the Commission needs more attention, reflecting an appreciation of expert advice in informing these policies. Thus, a more efficient mode of policy-related regulation is envisaged, combining effective decision-making with differentiated policy instruments. These need to account for aspects like the relationship between formal rules and non-binding policy tools such as recommendations, guidelines, and self-regulation. Additionally, flexible instruments like framework directives are appreciated together with the primacy of primary legislative instruments that are concerned with basic rules, which should leave their detailed actualisation to the executive. This approach is also prevalent with regard to the notion of co-regulation as a means for combining legislative and regulatory action with actions commonly taken by concerned actors in line with their expertise, thus allegedly promoting rule compliance (Commission 2001: 19-21).

At this point, the Commission discusses the "Open Method of Co-ordination", which has evolved as a flexible approach to sector-specific EU policy-making among various Member States, primarily in the areas of employment creation and social policy. It denotes a mode of co-operation through the monitored exchange of best practice in the context of common targets and guidelines. As the institutional character of the "open method" with its state-centred practices ranges well beyond the executive competence of the Commission, it is treated with critical distance, for it is said to potentially upset "the institutional balance" of European governance as defined in the Treaties – with the Commission as the decisive organ of centralised coordination and policy stimulation. Indeed, hinting at the established separation of powers as denoted by the "Community Method", it is argued that the "Open Method" should not be used when legislative action under the procedures of the Community method is possible (Commission 2001: 22-3).

However, this argumentation points to an exposed role for the Commission in reforming both the formulation and implementation of legal rules that is said to be indispensable due to the increasing institutional complexity following European enlargement. Indeed, the proposed reorientation of legislation by Council and Parliament towards basic issues should go hand in hand with simplified legal rules, involving the more extensive use of differentiated policy

tools like framework directives and co-regulatory mechanisms. This should allow for an improved application of these rules by the regulatory agencies of the EU, promoting their capabilities in drawing on sector-specific knowledge. Moreover, as the application of European Union rules on the national level remains in the domain of the nation-states themselves, strengthening their administrative capacity in terms of good governance strategies is viewed as decisive in proceeding with the rule of law. In this setting, monitoring the application of Community law should remain a task for the Commission, underlining its role as a guardian of the Treaties with supranational competences (Commission 2001: 23-5).

#### **4. REFORM PROPOSALS AND THE COMMUNITY METHOD OF GOVERNANCE**

Proceeding with its reform proposals, the Commission explicitly addresses the matter of global governance, claiming that domestic reform will enhance international change and thus support the role of the EU as an actor with global reach (Commission 2001: 26-7). As the reform proposals are directed towards a sustainable division of competences among the various organs and actors of EU multi-level governance, however, the White Paper goes on with discussing the need for refocused policies and institutions. Actually it is argued that refocusing policies would allow for identify more clearly the long term objectives of the EU: "These may, with the overall objective of sustainable development, include improving human capital, knowledge and skills; strengthening both social cohesion and competitiveness; meeting the environmental challenge; supporting territorial diversity; and contributing to regional peace and stability" (Commission 2001: 28).

In meeting these long term objectives, the Commission views itself as the decisive organ for initiating policy-related activities and steering the long-term agenda of European integration. Accordingly, the need for refocusing policies should promote the use of a revitalised Community method as an institutional framework that resembles a seemingly traditional yet controversial separation of powers between Commission, Council and Parliament: "Everyone should concentrate on their core tasks: the Commission initiates and executes policy; the Council and the European Parliament decide on legislation and budgets – whenever possible in Council using qualified majority voting, the European Council exerts political guidance and the European Parliament controls the execution of the budget and of the Union's policies" (Commission 2001: 29).

In particular, the Commission provides an assessment of its own function in the mechanism of European governance that underlines "Treaty tasks of policy initiation; execution; guardian of the Treaty; and international representation of the Community" (Commission 2001: 29). The Council of Ministers is

criticised for a lack of capacity in political leadership needed for arbitrating between sector-specific interests, allegedly facing the situation that the Union has moved from a “diplomatic process” of partly formal and partly informal bargaining procedures to a “democratic process” of rule-based, transparent negotiations among legitimised policy actors. The European Parliament and the parliaments of the Member States are then singled out for stimulating public debates on the course of European integration; a function that should accompany efforts in monitoring the execution of EU policies and the implementation of the budget. In doing so, policy-oriented control measures based on political objectives were to replace procedures of detailed accounting that would lack strategic considerations (Commission 2001: 29-30). This should lead to a situation where simplified legislation could outline the basic terrain for the Commission’s executive role, to be monitored by Council and Parliament. Thus, legislative practices should assist in restructuring the complex set of regulatory and management committees under the leadership of the Commission (Commission 2001: 31).

Following these considerations, the White Paper finally outlines the course of European integration as an institutional process that is based on well established principles of good governance, namely openness, participation, accountability, effectiveness and coherence, which are said to promote the related principles of proportionality and subsidiarity, prominent within the conceptual framework of the Treaties (Commission 2001: 32). Moreover, the principles of good governance are also interpreted as key concepts for promoting a political vision of multi-level governance in the European Union with the Commission as decisive organ for monitoring, guidance and political leadership.

This orientation is also emphasised by the summarising enumeration of strategic thrusts that are said to promote the reform of policy making and policy implementation in the European Union. Generally, the proposals in the White Paper are said to contribute to the restructuring of the European Union’s relationship with civil society, involving a code of conduct for consultation that addresses the matter of responsibility and accountability and by doing so enhances a public dialogue, which contributes to the openness of civil society organisations. A related topic is the potential for making use of the dispersed skills, capabilities and knowledge segments of regional and local actors. The proposals for reforming the mechanisms of European governance are thus to be interpreted as means for mobilising and using local knowledge for the purpose of the Community at large. In this line of reasoning, the European Union’s multi-disciplinary system for communicating expert advice is to be made more transparent by opening it up to extended public debates (Commission 2001: 33).

Further topics in the governance agenda of the Commission are outlined by emphasising the need for establishing a more flexible mode of promoting EU policies, combining formal legislation with non-legislative and self-regulatory

mechanisms. EU regulatory agencies should support these efforts by elaborating on sector-specific governance. Generally, a refocusing of the institutions of the European Union is taken to the fore. Yet these reform proposals are not necessarily linked with the requirement of Treaty changes, for the Commission underlines the need for political leadership within the established framework: "Carrying these actions forward does not necessarily require new Treaties. It is first and foremost a question of political will" (Commission 2001: 33).

Also the implementation of the reform proposals should primarily yield a refocusing of the decisive institutions in the scheme of European governance, namely Commission, Council, and Parliament. The proposals are meant to strengthen the leadership role of the Commission by allowing for a more targeted use of the right of initiative, as the mechanisms of consultation and involvement should support knowledge flows from other political institutions and civil society organisations. With EU legislation focussed on basic rules and regulations, Council and Parliament should be enabled to concentrate on long-run issues of political content in their legislative activities, while detailed operations are left to the executive, that is, the Commission. Therefore, the White Paper promotes strengthening the executive position of the Commission in a refocused separation of powers between the organs and actors of European governance (Commission 2001: 33-4).

In addition to the matter of competences among the organs of the European Union, the reconsideration of the mechanisms of multi-level governance in the process of European integration is said to require the effective involvement of national and regional organs and actors in the EU policy process, involving the formulation and implementation of adequate rules. At this point, the White Paper points to the need for intensified dialogue, institutional decentralisation as well as sustained co-operation between the involved administrations. Yet there is a second effect mentioned, which is oriented towards approaching national and regional governance organs as communicative transmission belts of the Commission, as they are designated for informing the relevant national and regional public about EU policies (Commission 2001: 34). Implicitly, therefore, the Commission assesses its own function as a nodal centre of communication networks with a European reach.

This self-assessment, as well as the underlying strategic orientation, are in line with the emphasis on a renewal of the Community method in the face of international governance challenges. Again, the Community method as a scheme for the separation of powers that is said to follow from the practice which has been established with the political formation of the Union, informed by the Treaty principles of subsidiarity and proportionality, is defined as follows: "This means ensuring that the Commission proposes and executes policy; the Council and the European Parliament take decisions; and national and regional actors are involved in the EU policy process" (Commission 2001: 34). While the Commission argues in favour of the co-decision proce-



ture that allows for taking joint decisions by Council and European Parliament, the Commission alone is to assume responsibility for executive action. Yet this scheme includes also an allocation of competences to the Union and the Member States, approached in terms of a vision of the future of “a Union based on multi-level governance in which each actor contributes in line with his or her capabilities or knowledge to the success of the overall exercise”, involving rules for sharing competences on different levels of the governance system (Commission 2001: 34-5).

The actual implementation perspective of these proposals was directed towards the Laeken Council, which was followed by a process of constitutional design in the European Convention that should provide the conceptual horizon for institutional reform. According to the Commission, several of the topics regarding institutional reform, as addressed in the White Paper, have been taken up in the draft constitutional treaty. This involves the general reference to a renewed Community method, yet also the emphasis on the principles of good governance in Article I-50 (Commission 2004: 12-13). Indeed, the Commission’s assessment of the Constitution speaks for itself: “The conclusion can therefore be drawn that the Constitution has incorporated the debate on the reform on European governance at the level of primary Union law” (Commission 2004: 14).

The current state of the constitutional project, however, provides decisive arguments for re-assessing the debate on the White Paper in terms of its strategic relevance – in particular with regard to the aspects of democratic participation and legitimacy, which have been identified as major problems in the failed ratification of the Constitution. Indeed, already the introductory remarks of the White Paper – pinpointing the fact that the Union is often seen as too remote and as too intrusive at the same time (Commission 2001: 3) – remain most significant for current attempts of realigning strategies for institutional reform with the preferences of the citizenry.

## **5. DEBATING THE WHITE PAPER: DEMOCRACY, LEGITIMACY AND MULTI-LEVEL GOVERNANCE**

Summarising the main points of the White Paper hints at the primary concern with institutional reform in the multi-level system of European governance by promoting principles like openness, accountability and responsibility. Regarding the aspects of participation, consultation and dialogue, the involvement of national, regional and local levels of policy-making is addressed, accompanied by a concern with the involvement of the organisations of civil society. In promoting flexible policy tools, paralleling a formalised role of expert advice, the corresponding policy framework should be made compatible with the principles of good governance. Yet underlying these concerns is

also the search for a well defined separation of powers, as the Commission emphasises its executive role.

This line of reasoning has been upheld quite rigorously in the Commission's subsequent interpretations of the White Paper: "The basic message was a simple one and is as topical now as it was then: we need to *govern ourselves better, together* – European institutions and Member States. We can do this *without changing the Treaty*, without necessarily waiting for the successful outcome of a new intergovernmental conference (Commission 2002c: 1, emphasis in original). Indeed, it is claimed that the Community method produces universal rules in support of legal certainty. The Commission then concludes on the dynamism of institutional reform in the setting of European governance: "Changing what is amenable to change, without necessarily awaiting a reform of the Treaties; and in doing so, safeguarding the conditions for legal certainty; clarifying ways in which the Treaties can be deepened, and thus facilitating reform of the Treaties: this is the basic element which has emerged from the concept of European governance" (Commission 2002c: 5).

Again, in the view of the failed ratification process of the European Constitution, this emphasis on the possibility of institutional reform within the established set of Treaties is a decisive point in the Commission's position, as promoted by the White Paper. While Commission, Council and Parliament should improve their interactions in the established framework of the separation of powers, the most significant implications of the governance approach are said to address the European Convention and its preparations for laying the groundwork of a European Constitution, perceived in terms of a "quiet revolution" (Commission 2002c: 5-6). However, since the project of the European Constitution has run into major difficulties while the separation of powers remains subject to controversies, currently mirrored by conflicts on budget affairs, the long-run view on the EU policy agenda is shaped by the need for coping with the status of participatory democracy in European governance.

This aspect hints first of all at the multi-level character of European governance, which has consistently shaped the Commission's further reflections on that topic: "European governance is about the principles and tools for decision-making within the context of the multiple layers of players and decision-makers in Europe — from the European Community, through the Member States, to regional and local authorities and private parties. The coexistence and intertwining of several governance levels clearly constitute unprecedented challenges" (Commission 2003: 31). According to the Commission's viewpoint, thus, the matter of governance is primarily a matter of the exercise of power, as governance comprises of "any rules, processes and practices that affect the quality of how powers are exercised" (Commission 2004: 3).

Moreover, the matter of participation implies a reconsideration of interactions with the organisations of European civil society: "Interaction between the Eu-

European Institutions and society takes various forms: – primarily through the European Parliament as the elected representative of the citizens of Europe; – through the institutionalised advisory bodies of the EU (Economic and Social Committee and the Committee of the Regions), based on their role according to the Treaties; – and through less formalised direct contacts with interested parties” (Commission 2002a: 1). According to related statements by the Commission, this perception of civil society addresses a variety of interested parties involved in the management of socio-economic affairs even beyond the “third sector” of civic activities: “So ‘civil society organisations’ are the principal structures of society outside of government and public administration, including economic operators not generally considered to be ‘third sector’ or NGOs” (Commission of the European Communities 2002a: 6).

Yet apart from civil society involvement as a requirement of deliberative democratic legitimacy, the underlying concern with steering and regulation addresses the functional coordination of knowledge. Indeed, the inclusive participation of civil society actors in the procedures of European governance should promote knowledge flows to the benefit of the steering efforts of the EU executive, that is, the Commission. Similarly, as outlined in the White Paper, expert advice is addressed as means for mobilising specific knowledge segments in the wider context of policy making: “Expertise forms an integral part of a dynamic knowledge-based society. Specialist know-how and skills help create new opportunities that can boost competitiveness and enhance our quality of life (Commission 2002b: 1). Related problems of decision-making under uncertainty, also owing to technological complexity, require the accountability, plurality and integrity of expert advice, as echoed by reforms concerning the system of scientific committees in the areas of food safety and consumer protection (Commission 2002b: 3-4).

What are the common concerns in these arguments on European governance – as promoted by the Commission’s White Paper and the elaborations it has stimulated subsequently? So far, academic discourse has been mostly critical of the White Paper, still acknowledging its stimulating role for subsequent developments in the discourse on institutional reform. The neo-institutional approach, in particular, which analyses the dynamism of both the processes of policy making and changes in their institutional conditions, has been most relevant for discussions of European governance (Kohler-Koch 2003: 10-11). Indeed, it has been claimed that debates on European democracy and the Constitutional foundations of European governance have commonly emphasised good governance in terms of efficient performance, stressing the aspect of “output legitimacy”, whereas more recent arguments have put an emphasis on democratic participation in terms of “input legitimacy” (Kohler-Koch 2004: 4). This distinction refers to a notion of output legitimacy as efficient political-administrative problem-solving in terms of “government for the people”; whereas input legitimacy denotes a political responsiveness to citizen’s preferences in terms of “government by the people” (Scharpf 2003: 2-3).

Thus, critical reconsiderations of the White Paper highlight its specific way of dealing with problems of input and output legitimacy, perceived in terms of the participatory accessibility of the process of policy making and the efficiency of its outcomes in a multi-level setting (Cygan 2002: 231). Basically, then, it has been suggested that the decisive problem of European governance is an implicit elitism combined with lacking democratic legitimacy, in particular regarding the self-stylised leadership role of the Commission. Instead, the need for more inclusive and participatory governance modes, as discussed in terms of the need for substituting output legitimacy by input legitimacy, requires a rule-based framework of democratic criteria (Kohler-Koch 2001: 5-8). Accordingly, the Commission's strategic neglect of an inclusive participation of democratic citizenship and organised civil society, favouring in its place a consultative feedback mechanism, is harshly criticised: "Participatory democracy is a bottom up process of raising voice rather than a top down one of granting consultation rights. This concept is clearly input-oriented and rests on a shared understanding that democracy is a social endeavour based on communication and social transaction" (Kohler-Koch 2004: 9).

Even more than that, the Commission's proposals have been denounced as a centralist and even authoritarian attempt of "the creation of a benevolent dictatorship" (Scharpf 2001: 7). However, this may suffice as a pointed characterisation of a conceptual trend in the White Paper's treatment of governance approaches, characterised by an implicit bias towards uniformity across the EU and accompanied by efforts in centralising competences for policy making with the Commission, as reflected by its promotion of the Community method (Scott and Trubek 2002: 15-6). However, in more cautious and defensive terms, it has been also claimed that the White Paper represents the Commission's efforts in countering the spread of cooperative ventures of Council and Parliament that would circumvent the Commission's authority through strengthening informal contacts in the framework of co-decision procedures (Héritier 2001: 1-2). This interpretation assesses the White Paper as an attempt of regaining an irreversibly decreasing role as centralist steering authority.

This argumentation points towards the political economy of European governance with its distinct pattern of conflict and cooperation among political organs and interest groups. Indeed, the governance approach to European integration needs to account for the fundamental role of power relations and dependency aspects in policy making and the exercise of political rule (Jachtenfuchs 2001: 258). Accordingly, Schmitter's definition of governance deals with aspects of credible commitment in political bargaining processes: "Governance is a method/mechanism for dealing with a broad range of problems/conflicts in which actors regularly arrive at mutually satisfactory and binding decisions by negotiating and deliberating with each other and cooperating in the implementation of these decisions" (Schmitter 2001: 4). The institutional domain of governance then includes innovative practices, based

on repeated procedures of deliberative interaction involving the evolution of trust and mutual accommodation between organisations. Governance is thus more likely to contribute to the solution of legitimacy problems in European policy making than conventional practices of hierarchical government (Schmitter 2001: 4-5).

The corresponding tendency of implementing new modes of governance in the European Union is well reflected by a perception of the Open Method of Coordination as a means for promoting “democratic experimentalism”, that is, a mode of decentralised decision making based on networks that are oriented towards establishing common standards through deliberative processes (Eberlein and Kerwer 2004: 133-4). Apart from the multi-level interactions between the designated legitimate actors of the process of policy making, however, such a perspective involves the communicative inclusion of a variety of organisation representing the diverse interests within an evolving civil society. For instance, in more concrete terms, the case has been made for restructuring the European Economic and Social Council. As it represents functional interests with an emphasis on neo-corporatist arrangements on the national level of interest aggregation, it is said to lack from a pluralist representation of the more diverse interest groups in European civil society (Kohler-Koch 2004: 15). In summary, thus, it is primarily the reference to multi-level governance in the Commission’s White Paper that remains of utmost importance for addressing European governance in its Post-Constitutional phase. Yet this perspective needs to be combined with an exploration of the institutional transformation of the nation-state and the related evolution of the actually existing European varieties of capitalism in order to produce a viable analytical framework for further reconsideration.

## 6. CONCLUSION

The persistent relevance of the Commission’s White Paper on European Governance may be derived from the attempt of combining a problematical modification of the division of competences between the Community organs with actually pressing problems regarding the combination of administrative efficiency and democratic legitimacy in a setting of multi-level governance. Adding to that dimension of institutional complexity, the process of economic globalisation exerts adaptive pressures on national and regional governance modes. An influential diagnosis of the situation of the European political economy thus draws on fundamental asymmetry and legitimacy problems that result from an institutional competitive pressure for deregulation on the national level, which contrast with the need for supranational modes of correcting market failure. Indeed, in this line of reasoning, the national varieties of capitalist market economies will prevail, while European policy making needs to remain consensual; whereas, attempts of establishing centralist modes of regulation on a European level, involving aspects like majority rule

accompanied by the Community method, are viewed as a recipe for disaster (Scharpf 2001: 4-5).

In proceeding with the matter of institutional variety, the perspective of differentiated integration is put forward, owing to the need for coping with both input- and output legitimacy in the European Union, placed in a setting of indispensable supra-national solutions that can deal with the regulation and correction of cross-border externalities, among others (Scharpf 2003: 17-8). The persistence of the institutional arrangements for economic coordination and power distribution that characterise the varieties of capitalist market economies still underlines the pointlessness in endorsing institutional convergence (Boyer 2005: 23-5). Europe is not to be envisioned as a hierarchical and unitary entity, endowed with institutional competences for wide ranging political steering as implicitly suggested by the White Paper. Rather, a viable political project of European integration needs to account for the persistence of the nation-state and thus for the requirement of establishing an inclusive mode of Europeanising identities that could be promoted by an array of transnational intermediary organisations (Kohler-Koch 2001: 13-4).

In conclusion, then, a model of transnational pluralism in the European Union would imply a type of disjointed pluralism and competitive federalism with differentiated regional, national and supra-national levels of interaction that cover diverse actors and interests (Streeck and Schmitter 1992: 227). Yet European governance becomes ever more complex due to the ongoing process of globalisation, as the nation-state is transformed into a complex structure of associations that confronts its capacity for economic regulation. The corresponding institutional architecture functions as a polycentric system that coincides with a drive for shared sovereignty in cooperation and integration (Cerny 2000). At this point, at last, reconsidering the perspective of global governance, as presented in the White Paper, may contribute to a more substantial understanding of the institutional processes underlying the future course of European governance – thus also addressing the project of European integration in general.

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## POLICY TRENDS ON TRANSFER PRICING IN CHINA\*

### ABSTRACT

Transfer pricing by multinational companies is a topical issue in international tax legislation in many countries. The focus of this paper on this issue is China, the biggest recipient of foreign direct investments in the world in recent years. Our study of transfer pricing policy trends and regulations is from the Chinese tax authority and government perspectives. Based on a critical examination of the development of these policies and regulations over time in China, we analyse features and related problems of the current situation. The paper also identifies factors that influence the transfer pricing tax system in China, proposing future policy options and suggesting possible improvements in the system.

### 1. INTRODUCTION

Transfer pricing (TP) is a mechanism by which one segment of an organisation charges another segment of the same organisation for goods and/or services transferred to it. This practice is common in domestic and multinational companies (MNCs). In domestic firms, the primary objective of transfer pricing is to support a system of management control to improve segmental results and the performance of the firm as a whole. When the segments are interdependent, the ultimate goal is to achieve goal congruence between the segments and the firm. Failure to do so could lead to sub-optimisation.

In MNCs, the goals of transfer pricing are different. While the focus in domestic companies is on goal congruence and motivation, MNCs use transfer pricing to minimise their corporate tax burdens and payment of import duties and tariffs to their host countries worldwide. The incentive of MNCs to fix transfer pricing to achieve their goals is well-known to host countries in which the MNCs operate. Transfer pricing policies in such host countries are usually formulated to check transfer pricing malpractices by the MNCs.

This paper critically examines the development of transfer pricing policies and regulations in China, with particular reference to MNCs. Although it is a China-based study, other economies and potential foreign investors can also

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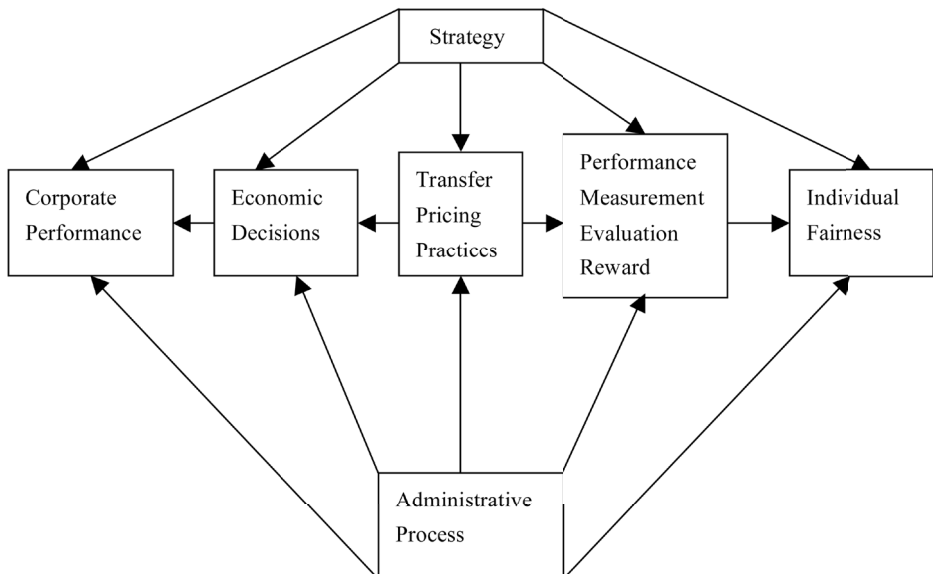


learn from the changing trends in China's policy-making experience. The rest of this paper is organised in four sections. Section 2 reviews the theoretical issues of TP. Section 3 examines the evolution of transfer pricing regulation in China, and subsequently develops the above framework to analyse features of the current situation in China. Section 4 discusses factors that influence the transfer pricing tax system in China. In the light of the conclusions derived, it forecasts future policy options and suggests possible improvements that can be made. Section 5 concludes the study and makes recommendations for further research and policy changes.

## 2. THEORETICAL ISSUES ON TRANSFER PRICING

Transfer pricing, as earlier defined, is a complex process. In operational terms, Eccles (1985) conceptualises it as a central element in which strategy and administrative process serve as inputs. At the same time, there are four other inter-related variables of corporate performance, economic decisions, performance measurement, evaluation and reward systems and ethics in individual fairness, which are each influenced by both the central element of transfer pricing practice and its inputs of strategy and administrative process. The effectiveness of transfer pricing as a function of each of these variables is determined largely by the effectiveness of the strategy and administrative process within the organisation. Figure 1, which shows the cause-effect relationship of transfer pricing, vividly captures its strategic and administrative dimensions as viewed by Eccles (1985).

Figure 1. – THE CAUSES AND EFFECTS OF TRANSFER PRICING



Source: Eccles (1985).

Eccles goes on to demonstrate how economic theory, accounting and management theories, can be used as a framework within which to explain the various strategies involved in transfer pricing. This is summarised in Table 1.

From Table 1, we can see that relevant elements of the three disciplines indicated above are interrelated. Economic theory, for example, assumes that in a divisionalised firm, the managers of both the buying and selling divisions in a transfer pricing process would want to maximise their individual profits. Under these circumstances, they would search for the transfer pricing strategy that would also maximise the total profits of the firm, if goal congruence is to be achieved. Accounting, on the other hand, assumes that transfer pricing affects resource allocation decisions of each division and the price of the intermediate product that the selling division transfers to the buying division. Management theory tends to focus more on the firm's long-run strategy than short-term profit maximisation and performance of individual divisions. The focus is on optimal transfer pricing determination and goal congruence.

Table 1. – THREE MAIN THEORIES ABOUT TRANSFER PRICING

Theory	Related Elements with TP
Economic	Economic decisions, corporate performance
Accounting	Administrative Process Economic decisions, corporate performance
Management	Performance measurement, evaluation and reward Strategy, Administrative process Performance measurement, evaluation and reward, individual fairness

Source: Adapted from Figure 1

## 2.1. DOMESTIC TRANSFER PRICING

Transfer pricing in domestic firms has attracted the attention of researchers over the years. Examples include Hirshleifer (1964), Kaplan (1984), Eccles (1985), Johnson *et al.* (1987) and Ansoff *et al.* (1990) who have traced the origin of transfer pricing to a by-product of decentralisation of large companies and the advent of divisionalised companies in the USA in the early 1920s. In this context, managerial accounting textbooks tend to regard transfer pricing as an instrument for achieving decentralisation and coordination in multidivisional firms. Consequently, some writers see the role of transfer pricing in domestic enterprises in terms of providing the valuation base for intermediate products and services so as to facilitate transactions across profit centres (Horngren *et al.* 2002, Jiambalvo 2001, Kaplan *et al.* 1998). Domestic transfer pricing may thus be viewed as a problem of cost-profit allocation which influences financial results. While transfer pricing is a cost to the receiving division, it constitutes a source of revenue to the supplying division. Transfer pricing thus not only affects performance evaluations, but also influences decisions on the cost of input and revenue generated from the sale of output.

These are two fundamental issues in domestic transfer pricing: decision making and performance evaluation in divisionalised firms.

Because of the divisional interdependence and potential disharmony between them and the firm, transfer pricing conflicts are unavoidable and frequently exist in decision-making (Spicer, 1988; Hodgetts, 1996) and performance evaluation. Williamson (1986) describes this as the “hold-up” problem involving both inter-divisional conflict and the conflict between divisional and firm-wide interests. The Dual Concern Model and Game Theory Model are two models often applied in conflict resolution. Conflict resolution in transfer pricing is the optimal transfer price that leads autonomous profit divisions to make decisions which would maximise firm profits (Hirshleifer, 1956). Besides Hirshleifer’s study of domestic transfer pricing conflicts and resolutions, academic interest has also been directed to methods of transfer pricing determination. The comparison between cost-based and market-based transfer pricing methods will be discussed in section 2.3.3. However, the above two research dimensions are concerned with short-run goals and tend to ignore long-term considerations. But as we argued earlier, transfer pricing also has behavioural and organisational implications and its relationship to economics, management and accounting disciplines. In recent times, a gradual shift of emphasis has been observed in various researches. Boyns *et al.* (1999), for example, in their longitudinal study of transfer pricing, found that corporate history, power and evolution, are all important in transfer pricing. Van *et al.* (2001) also noted the history and organisation factors in both transfer pricing and management control systems. Furthermore, Perera *et al.* (2003) drew attention to the importance of the process and dynamics of transfer pricing, as well as its interactions with organisational strategy, structure and culture. They concluded that the role of transfer pricing as an accounting mechanism can induce cultural and strategic change in organisations and create a reciprocal relationship between transfer pricing and organisational strategy over time.

The current economic globalisation has led to a phenomenal increase in the growth of multinational companies. There is no doubt that foreign direct investment by multinational companies can contribute significantly to a country’s economic growth and development. This has generated interest among research on international transfer pricing which we discuss in section 2.2 that follows.

## 2.2. INTERNATIONAL TRANSFER PRICING

Globalisation, in the context of cross-border transfers, according to Harrison *et al.* (2000), is used to describe the increasing interdependence of business activities throughout the world, from the “global” material market, “global” selling market, “global” labour market to “global” capital market. Here, “global” is synonymous with “cross-border”. It is globalisation that led to a significant

emergence of MNCs and their increasing role in the world economy. In 2002, the United Nations Division on Trans-national Corporations and Investment estimated that there are almost 65,000 MNCs, whose sales amounted to nearly 60 per cent of the world gross domestic product (GDP). Although there is no generally accepted definition of MNC, the common feature among various descriptions is “trans-nation”. For example, the United Nations (UN) regards MNCs as “trans-national corporations” which are “enterprises which own or control production or service facilities outside the country in which they are based”. According to Harrison *et al* (2000), a more detailed portrait of MNC is that of an enterprise which extends its business activities into more than two countries with the aim of responding to worldwide opportunities for the most efficient employment of its firm-specific assets, including its production and service facilities and knowledge, either on its own or in partnership with other firms, in pursuit of clearly-defined aims and objectives. Among various operating strategies, the two most popular methods used by MNCs to expand their economic activities are exporting and foreign direct investment (FDI). Between 1980 and 2003, world exports of goods and services more than doubled in real terms, reaching over USD 7,500 billion in 2003 and accounting for over 23 per cent of world GDP. Over the same period, flows of world FDI have almost quadrupled in real terms, reaching around USD 700 billion in 2003 (Stuart *et al*, 2004).

However, both domestic firms and MNCs have profit maximisation and risk minimisation as one basic motivation. But, unlike domestic firms, MNCs face a more complex environment characterised by potential problems of government restrictions and cash flow in foreign subsidiaries; customs duties, anti-dumping and monopoly legislations; inflation and currency fluctuations; royalty and management fee restrictions and local partner interests; relationship with host countries and performance evaluation of subsidiaries (Tang, 1982). Under such situations, there are a number of factors that will influence MNCs in their international transfer pricing considerations as compared to domestic firms. They include control concentration of cash; minimisation of global tax liability, including customs and excise taxes; reduced exposure to risks of inflation and exchange rate fluctuations; avoidance of repatriation of dividends restrictions; improved competitive advantage by providing “cheap” finance; management of joint ventures involving foreign partners; maintaining good relations with host countries and the public in general; provision of relevant performance measures for segments of the enterprise (Daniels, Ogram and Radebaugh, 1976). These complications are part of the main features of MNCs’ cross-border operations. Since there are subsidiaries operating in different countries with different tax rates, the key role of international transfer pricing is essentially worldwide tax burden minimisation.

Empirical evidence has shown that MNCs use transfer pricing as a mechanism for tax avoidance. For example, Ernst & Young, a reputable international firm of Chartered Accountants, has taken great interest in international tax

matters of multinational enterprises, in relation to transfer pricing. It has developed a biennial transfer pricing survey and research. In 2003, it surveyed over 800 businesses (with 641 parent companies and 200 subsidiaries) in 22 countries to find out their international practices and perceptions regarding transfer pricing. It also interviewed tax authorities and experts in 44 countries with transfer pricing regimes. The survey results concluded that transfer pricing remains the most significant international tax issue today and is likely to remain so in the foreseeable future. In their survey report, Ernst & Young showed that 86 per cent of parent and 93 per cent of subsidiary company respondents identified transfer pricing as the most important international tax issue they currently face. Of all the surveyed respondents, 68 per cent identified transfer pricing as the biggest international tax issue they expect to face in the next two years (Ernst & Young, 2003). The result highlights transfer pricing as a topical issue in international taxation around the world that is likely to interest researchers, practitioners and other parties.

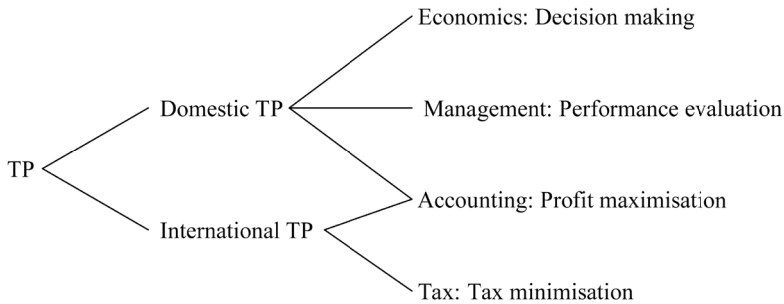
Thus accountants, lawyers, researchers in finance and economics, should be interested in MNCs' transfer pricing practices. Each would analyse the problem from their individual perspectives. MNCs would want to make full use of transfer pricing to decrease their tax burden and increase total operational profit from host countries. The host country governments and tax authorities would introduce laws and regulate transfer pricing practices of multinational companies to check possible tax evasion. Accountants and lawyers, providing services to multinational companies as their clients, would tend to advise them on how to use transfer pricing to achieve their goals within the framework of the law and laid down regulations. Researchers, interested in advancement of knowledge, would take a critical look at transfer pricing practices to identify aspects capable of providing evidence to enhance and enrich existing knowledge and theories. Some international transfer pricing methods, such as cost-based and market-based approaches, are similar to that of divisionalised domestic firms, and will be discussed in more detail in section 2.3.3.

Cross-border operations, as the main feature of international transfer pricing, have directed the attention of researchers to the impact of different taxes in different host country jurisdictions. Included in the areas of research interest is the incidence of international transfer pricing manipulation aimed at minimising the incidence of global tax burden by multinational companies. Examples of such researchers include Rugman and Hodgetts (1995), Shapiro (1992), Radebaugh and Gray (1997). Other empirical studies of U.S.-based firms have provided evidence of international transfer pricing manipulation by multinational companies to reduce their corporate tax burdens. For example, Jacob (1996), Harris (1993) and Klassen, Mark Lang and Mark Wolfson (1993) used U.S. firms for their study company samples. Another aspect of interest to researchers has been multinational companies' income shifting strategy through transfer pricing manipulation before and after tax rate

change and tax law revision. The study by Oyelere and Emmanuel (1998) also confirms international transfer pricing as an income-shifting mechanism with evidence from multinational companies in the UK. Other studies have found the tension between tax compliance and management control in international transfer pricing (Halperin and Srinidhi, 1991; Sansing, 1999 and Smith, 2002). The most recent study on the integration of managerial transfer pricing and tax transfer pricing (Baldenius, Nahum D. Melumad and Stefan Reichelstein, 2004) shows how to set an optimal transfer pricing to attain goal congruence both for tax and management control purposes.

In summary, figure 2 illustrates two dimensions of transfer pricing for both domestic and international firms. In spite of their basic difference in transfer pricing motivation, both have a common goal of profit maximisation.

Figure 2. – DOMESTIC AND INTERNATIONAL TRANSFER PRICING



Source: Authors' Formulation

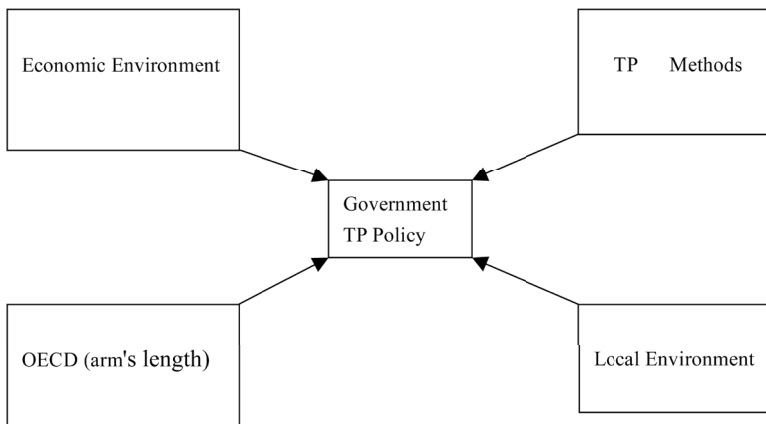
### 2.3. GOVERNMENT PERSPECTIVE

Although there is substantial literature on international transfer pricing, most previous studies seemed to focus on MNCs and their transfer pricing methods. Others concentrate on introducing transfer pricing tax regimes of some countries (Feinschreiber, 2000; Happell and Michael, 2003; Hurtado, Mauricio and Ahrens, Edgar, 2004). The main function of such introductions of legislation is to provide MNCs with a full understanding of transfer pricing tax laws in each region. Few studies have examined and analysed critically the transfer pricing laws and regulations of China. This paper, which examines policy trends and problems from the perspective of the Chinese government, is a modest attempt to fill this gap. We first study the chronological development of transfer pricing regulations in China. This is followed by analysis of the effects of the policies on multinational companies in China within the unique Chinese economic environment. We believe that the primary purpose of China's State Administration of Taxation (SAT) reforms of transfer pricing rules in China is to solve problems as they arise. The trend of future policies would then become obvious. Based on the analysis of current shortcomings,

recommendations can be made on possible improvements of the future tax system. The findings of this study on China's experience should benefit other countries interested in policies aimed at introducing laws and regulations on transfer pricing practices of multinational companies operating in their countries.

In a transfer pricing context, MNCs and government appear to be opponents in a two-person zero sum game in game theory. They struggle and compete against each other indefinitely. While multinational companies make full use of transfer pricing manipulation to minimise their tax burden, the host country government, on the other hand, formulates transfer pricing policies to control the situation and enhance its tax revenue. The actions of each influence and determine the other's behaviour. But the dynamics of the environment around them remain the same. There are some principal factors such as economic development, local characteristics, international rules and transfer pricing methods that are important to both. In our study, we first formulate a simple framework which includes those elements that influence government transfer pricing policy-making. The details of the framework shown in figure 3 are analysed in section 2.3.1.

Figure 3. – TRANSFER PRICING FROM GOVERNMENT PERSPECTIVE



Source: Authors' Formulation

### 2.3.1. ECONOMIC ENVIRONMENT DEVELOPMENT

Globalisation may arguably be considered as the most dominant international feature of the world's economic environment in the 21<sup>st</sup> century, with internet economy and knowledge economy as its two main streams and electronic commerce and intangible assets as its direct products.

Broadly defined, electronic commerce (e-commerce) involves transactions that facilitate the delivery of information, products, services, or payments by telephone, computer, or other automated media (Rolph, Brad and Nieder-

hoffer, Jay, 2002). The basic feature of e-commerce transactions is the lack of physical entity, which leads to differences between on-line and traditional transactions such as virtual location, e-cash payment and electronic books. There are two main types of e-commerce: business-to-business and business-to-consumer. Because of the volume and complexity of e-commerce, its cross-border transactions pose challenges to existing transfer pricing rules and regulations. This problem has attracted different viewpoints from researchers on how e-commerce affects transfer pricing. Maguire (1999) has argued that e-commerce may not induce new transfer pricing questions, but only magnifies existing issues; the Organisation for Economic Co-operation and Development (OECD) also thinks that existing principles related to e-transfer pricing transactions are adequate (Wagdy, 2002). Opposing these views, Wagdy (2002) argues that current transfer pricing tax regulations were written within the framework of a business environment that existed before the emergence of e-commerce. Practically, the difficulty in identifying, valuing and verifying e-commerce transactions further increases the difficulty in applying worldwide accepted transfer pricing methods to it for MNCs, tax authorities and international organisations. Thus tax management of e-commerce transfer pricing, as a number one issue for MNCs, has become the most difficult area of international taxation in the 21<sup>st</sup> century. The key point in e-commerce transfer pricing is permanent establishment (PE). The definition of a PE, a term used by the U.S. and more than 50 other countries having treaties with the U.S., is: the requirement that enterprises must own or lease, as well as operate, the server; the server must be in place for a specified period of time; there must also be human intervention and the server must perform a core function. However, OECD has developed a new PE definition in which human intervention is not required to create a PE for tax purposes (Susan, 2003). Although OECD maintains that e-commerce transactions can be handled by existing guidelines, it admits that the character of the transaction will increase the complexity of analysis. So OECD administrators have established five technical advisory working groups (TAGs) to address specific e-commerce tax issues on transfer pricing.

According to Lev (2000), the main drivers of economic value creation and economic growth in the modern era are intangible assets. MNCs invest in various intangible assets such as research and development (R&D), franchise and brand, as well as human capital enhancement to improve their competitive advantages at a faster growing rate than in physical capital, especially in developed economies. Intangible property includes rights to use industrial assets such as patents, trademarks, trade names, designs or models, including literary and artistic property rights and intellectual property such as know-how and trade secrets (OECD, 2001). OECD (2001) guidelines concentrate on business rights, i.e. intangible property associated with commercial activities, including marketing activities. As modern accounting practices cannot accurately capture the value of intangibles, they are usually excluded from



MNC balance sheets (Przysuski, Sri Lalapet and Hendrik Swaneveld, 2004). But, OECD points out that intangibles are assets that may have considerable market value even though they may have no book value in financial accounting terms. Because of the difficulty in the measurement of intangible assets, three fundamental issues affecting their transfer pricing analysis have arisen: identification, creation and ownership. For example, there are two ownership principles that must be addressed: legal ownership and economic ownership. It is quite a challenge to determine ownership of intangibles within MNCs from these two different perspectives, especially when intangibles are jointly developed by many members of the MNC group. In such a situation, it is important to clarify relative contributions made by each member of the group during the development of specific intangibles. On the basis of this, the analysis of transfer pricing involving related party transactions on intangibles will be accurate. It may therefore be concluded that comprehensive analyses of intangibles will serve to account accurately for their value and ownership while complying with transfer pricing regulations in different countries (Przysuski, Sri Lalapet and Hendrik Swaneveld, 2004 II). Practically, increasing attention has been paid to transfer pricing of intangibles by both MNCs and tax authorities. Key findings of the transfer pricing 2003 global survey by Ernst & Young also show that intangibles are attracting increasing attention from tax authorities worldwide. Furthermore, intellectual property and financing transactions are more likely to result in relevant adjustments.

### 2.3.2. THE ARM'S LENGTH PRINCIPLE (ALP)

The most acceptable international transfer pricing guideline in the world is the arm's length principle (ALP) established by the OECD. The authoritative statement in paragraph 1 of Article 9 of the OECD document, *Model Tax Convention*, states that "[When] conditions are made or imposed between...two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly". This simply means that transfer pricing between business associates should be the same as between independent companies. Although the OECD has made great strides in developing international transfer pricing guidelines for many years from the perspectives of both multinational companies and tax administrations, the guidelines are not only for OECD member countries, but have also been adopted as a basis for transfer pricing regulations in many others. However, if we study in detail the keywords in the document, we would find that the practical application of ALP is restricted by many limitations. Besides, there has been much criticism of ALP in recent studies, although no suggestion has been made of any alternative that would achieve the results intended by ALP.

Francescucci (2004), for example, points out two shortcomings of ALP. One is conceptual and the other process-related. The conceptual shortcomings include the fact that multinational company subsidiaries are totally different from independent parties and transactional structures. Process-related shortcomings include those factors which hamper ALP application, such as various ALP interpretations, yearly transactional analysis, negotiations with tax authorities and the volume of documents required. The main argument of this paper is that ALP lacks a sound theoretical framework. Furthermore, the basis of ALP is profit allocation among similar independent enterprises. It therefore needs separate accounting methods or separate entity approaches to analyse the characteristics of the relevant transactions and the relationship between associated parties. To fulfil the task, both functional and comparability analyses are necessary, though these may be difficult and time-consuming. Thus, even the OECD's Centre for Tax Policy and Administration has admitted that although there are OECD guidelines, it is still not always feasible to apply ALP in a transfer pricing setting, especially to find comparable data (Neighbour, 2002).

### 2.3.3. TRANSFER PRICING METHODS AND THE LOCAL ENVIRONMENT

To apply ALP, OECD classifies transfer pricing methods into traditional transactions and other categories. Traditional transactions methods include: comparable uncontrolled price (CUP), resale price and cost-plus methods. Although traditional transactions methods are most direct, there are some restrictions in their practical adoption. To solve the resulting problem, some less preferred alternative approaches are sometimes adopted. They include transactional profit methods and transactional net margin method/comparable profit method (CPM). According to OECD guidelines, it is only when there are practical difficulties in applying traditional transaction methods, that other methods can be applied. In particular, CPM can only be adopted if it is consistent with the guidelines (OECD, 2001).

As regards possible solutions to the transfer pricing problem, the OECD and the United States have always tended to adopt different approaches. While OECD prefers to apply ALP at a transaction level (i.e. comparing the related and the unrelated at each transaction), the United States, as a pioneer in the TP field, developed its own application of the best method rule, CPM. This is because the U.S. does not consider the comparison of the per-transaction method feasible in a complex economy. As a result, the U.S. prefers the comparison of profits over a period of time using CPM. ALP and CPM have attracted the attention of researchers in recent years. These include Pim (2003), Casley and Artemis Kritikides (2003) and Hamaekers (2003). However, these researches have reached different conclusions. Hamaekers (2003), for example, concluded from his study that CPM as a qualified transfer pricing method, does not comply with the ALP, applying the conditions of the OECD guidelines. Casley and Kritikides (2003) consider the criticism of CPM

unnecessary. According to them, although every other method may appear better than CPM, they still have their own shortcomings. So it is somewhat incorrect to say that CPM can never be ALP.

The global formulary apportionment has been suggested as an alternative to ALP. This is the global formulary apportionment. This method allocates profits of MNC among its subsidiaries in different tax jurisdictions based on a predetermined formula. The advocates of this approach do not agree with the appropriateness of the separate entity approach favoured by ALP. They think it is better to consider the relationship of associated parties in MNCs on a group-wide basis. But Neighbour (2002) points out that except for its theoretical superiority, the global formulary apportionment would have difficulty in deciding appropriate variables to use in the formula, especially under challenges from recent developments such as global economy, electronic commerce, intellectual capital and research and development (R & D). One may conclude that it is much better to update the existing system than start a thoroughly new one. But it may also be argued that no matter which transfer pricing method is chosen, whether it is set up by OECD or adopted by a MNC, it should have adequate supporting data. So it may be incorrect to conclude that any one method of transfer pricing is more consistent with ALP (Casley and Artemis Kritikides, 2003).

Every country has its peculiarities. In this study, we have selected China as a developing country for our study. As transactions between China and the rest of the world have increased rapidly in recent years, the importance of transfer pricing policy trends, rules and practice in China has increased correspondingly. In Section 3, we analyse China's experience with transfer pricing, along with its development and problems. Given the framework of the theoretical issues discussed in Section 2, we may now consider China's experience with transfer pricing.

### 3. CHINA'S EXPERIENCE

As a rapidly developing country, China continues to open its doors to the outside world especially after its accession to the WTO. More and more multinational companies are investing in China, regarding it as a global manufacturing entity and a potential world market. According to the latest (June 28, 2004) news release by OECD, China overtook the U.S. in 2003 as the biggest recipient of FDI for the second year running, attracting USD 53 billion. In spite of the fact that the flow of FDI into China has risen significantly in recent years, many multinational companies in China have been declaring losses, leading to the popular saying in China, "loss on surface, profit in essence". This phenomenon has led not only to the loss of tax revenue in China, but also the incorrect image of China as an unprofitable investment prospect. This is caused by multinationals shifting profit through transfer pricing. Legislation became necessary and in 1998, China became the second country in

Asia (after Japan) to pass transfer pricing legislation, the Chinese State Administration of Taxation (SAT) issued detailed transfer pricing regulation *Tax Administration and Procedures for Transactions between Related Parties*. The Chinese tax system is not perfect in practice. To keep in line with international practice, there is a need to borrow from successful experience abroad.

The State Administration of Taxation (SAT) has made many efforts in this direction in recent years. In September 2004, for example, SAT in China issued Guo Shui Fa [2004] 118- *Implementation Rules on Advance Pricing Agreements for Related Party Transaction*, which has become a generally accepted method of transfer pricing in many countries since its introduction in the United States in 1991. It provides formal guidance for APA between MNCs in China and SAT, after years of delay. Although the new regulation complies adequately with international rules, it does have some shortcomings. In the process of internationalisation, we should fully consider China's national economic conditions, while applying the rules. For example, there is one special feature of transfer pricing in China: contrary tax-avoidance. It is a common practice among multinational companies to shift corporate income from high to low corporate income-tax countries in order to reduce the tax burden. This is the normal objective of transfer pricing. But to attract more foreign investors, the tax rate for foreign investors in China is quite low compared to what exists in other countries. It is generally observed that many multinationals in China engineer losses by buying high from, and selling low to, related parties in order to shift profit overseas. We call it contrary tax-avoidance. In the section that follows, we will analyse the current situation, chronological development, special feature and realistic problems of the transfer pricing regulation in China.

### 3.1. THE CURRENT INVESTMENT CLIMATE

Since China started to open its doors to the outside world, it has also continued to grow as a potential global market. FDI into China has risen rapidly in recent years. After China's entry into WTO, a 15 per cent increase in the invested value of FDI has been reported. By the end of August 2004, more than 494,025 foreign-investment enterprises (FIE) had been approved and used value amounted to USD 54.5 billion (Liziqin, 2004). These FIE introduced high technology, management experience and investment capital into China. But the question that arises is the real impact of these enterprises on China's economy. Statistics from the Chinese Ministry of Commerce have shown that out of more than 490,000 FIEs operating in the country, between 51 per cent and 55 per cent reported losses. Yearly losses amounted to RMB120 billion (approximately USD 15 billion) and the trend seems to be increasing. Between 1988 and 1993, 35 per cent~40 per cent of FIEs reported losses; between 1994 and 1995, 50 per cent~60 per cent; between 1996 and 2000, 60 per cent~70 per cent (State Administration of Taxation, People's Republic of

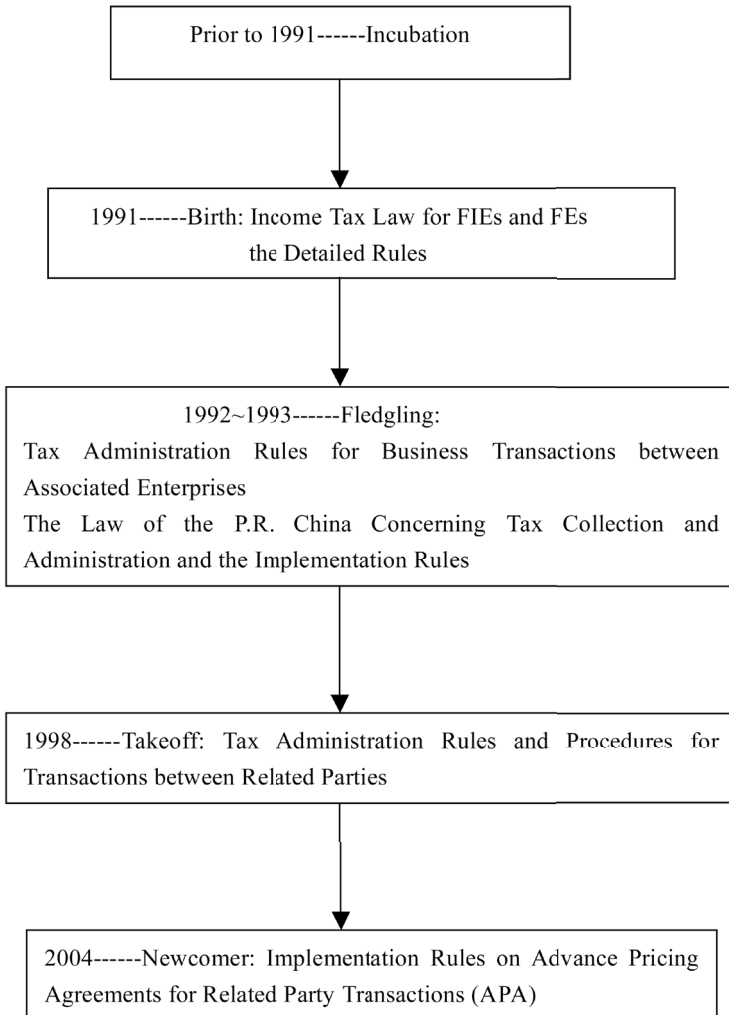
China). It is ironic that in spite of these reported losses, the FIEs have continued to expand their operations. Indeed, as Chinese would say, many FIEs “report losses on surface, but enjoy profits in essence”. They repatriate income from China and avoid taxes. According to Chinese tax officials, the Chinese government has been receiving less corporate income tax than it should - at least RMB30 billion (approximately USD 3.75 billion) yearly from FIEs. Of the reduced tax liabilities, 60 per cent are realised with the tool of transfer pricing in multinational companies. (Liziqin, 2004). Chinese tax authorities have noted that many FIEs make losses by buying high from, and selling low to, associated parties, including goods, property, services, loans and leases. This is a transfer pricing mechanism which essentially shifts profits and avoids tax. From 1995 to 2001, Chinese tax authorities audited accounts of nearly 12,800 companies and discovered additional taxable income of RMB13.8 billion (USD 1.7 billion) and earned additional tax revenue of RMB1.1 billion (USD 132.5 million) (Ernst & Young, 2003). From these data, we can understand why China is paying more attention to transfer pricing methods within FIEs than ever before. At the same time, Chinese tax authorities are making every effort to improve the country’s machinery of tax administration. But, as the legislation for transfer pricing is at an initial stage, problems are inevitable. To improve the system, it is necessary to understand and analyse the development of transfer pricing regulations, its main obstacles and special feature. In the next section, we examine the development of transfer pricing regulations in China.

### 3.2. THE DEVELOPMENT OF TRANSFER PRICING REGULATIONS

Chronologically, the history of the transfer pricing tax system in China can be divided into 5 periods as shown in figure 4, namely, prior to 1991, 1991, 1992-1993, 1998 and 2004. According to SAT, prior to 1991, there was no tax law in China on transfer pricing although the government was aware of what was going on in FIEs. The period prior to 1991 can be described as an incubation period. As the first Specific Economic Zone (SEZ) in the country, Shenzhen province in China experienced many FIE tax avoidance practices by FIEs through transfer pricing. In 1988, the city government drew a *Temporary Tax Regulations on Transactions between Associated Parties within FIEs in Shenzhen SEZ*. This was the first transfer pricing regulation in China. Although it was only local and experimental, it became an embryo for future regulations. In 1991, a transfer pricing-related tax law was passed in China: *Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises which was followed by Detailed Rules for the Implementation of the Income Tax Law of the People’s Republic of China for Enterprises with Foreign Investment and Foreign Enterprises*. Article 13 of this law requires that FIEs deal with associated parties under the ALP, widely adopted by OECD, the United States and other industrial countries. Thus, no

FIE subsidiaries were allowed to buy products from, or sell to, their parents at a price significantly different from the market price. To shed light on the above law, the government released some explanatory documents to define terms such as identification of associated enterprise, report of transactions with related parties and information to be disclosed among others. For effective implementation of the related law, SAT also released a circular, *Tax Administration Rules for Business Transactions between Associated Enterprises*, in 1992, which further clarified the definition of associated enterprises and its reporting requirement and supporting evidence. In 1993, transfer pricing-related issues were incorporated into the *Law of the People's Republic of China Concerning Tax Collection and Administration*. This law enriched and

Figure 4. – CHRONOLOGICAL DEVELOPMENT OF TP TAX RULES IN CHINA



Source: Authors' Formulation

consolidated the transfer pricing tax system in China. In 1998, the SAT issued the first comprehensive transfer pricing regulation, *Tax Administration Rules and Procedures for Transactions between Related Parties*, which consolidates previous transfer pricing legislations at both procedural and substantive levels. It marked a significant transfer pricing tax system set up in China. Furthermore, the latest development on transfer pricing regulations in China is the Guo Shui Fa [2004] 118- *Implementation Rules on Advance Pricing Agreements for Related Party Transaction (APA)* issued by SAT in September 2004, after several years of delay in preparation. It represents the most comprehensive and all-embracing transfer pricing legislation in China that incorporates international transfer pricing rules.

Although the law has been firmly established, the system, which appears rudimentary, still requires further improvement and refinement. In the course of its application, many problems have been encountered. Some have argued that the regulation is too abstract to provide appropriate and operational guidelines for effective implementation. In the next section, we discuss the main problems that have been identified.

### 3.3. MAIN PROBLEMS

The main problems associated with the transfer pricing tax laws and regulations in China are various. Several defects in the tax system include: audit scope, adjusting method, documentation and penalty for non-compliance. Each of these is discussed in further detail.

#### 3.3.1. AUDIT SCOPE

The recognition of associated enterprises is the first step in transfer pricing audit. The nature of the relationship between two corporate entities is defined by the extent of ownership and control. Two corporate entities are regarded as being associated for transfer pricing purposes, if they have to classify inter-entity transactions and account for them on the basis of ALP. According to the Chinese tax legislation, related parties are defined as companies with direct or indirect ownership of 25 per cent or more. It is much lower than the OECD level of 50 per cent. It seems that more companies in China are subject to transfer pricing regulation. But in reality, it would be necessary to align with international rules which emphasise a high level of efficiency. According to SAT, China is rather short of experience in transfer pricing investigation. For example, between 1991 and 2000, 18,000 FIEs with related-party transactions were audited, but only 6,000 (or 33 per cent) of them yielded positive results. And at the same time, the audited proportion is really small.

Current transfer pricing rules in China require that tangible assets be priced on a “transaction basis” and on which the tax bureau may make relevant adjustments. The regulation itself offers few guidelines on services and intan-

gible assets. Consequently, Chinese authorities have been focusing attention mainly on tangible transactions. But within recent developments in the global economy, it is to recognise the impact of high technology, knowledge economy and e-business on cross-border transactions. Ernst & Young's transfer pricing 2003 global survey has shown that although tangible goods account for a high proportion of audits, taxpayers and administrators are paying more attention to services and financial transactions. Intellectual property, knowledge economy, e-business and financing operations are more likely to result in adjustments. To accommodate these, the Chinese tax system should be modified to recognise other inter-company transactions in addition to those involving tangible assets.

### 3.3.2. ADJUSTMENT METHOD

The Chinese tax authorities have stipulated four adjustment methods to transactions on tangible assets between related parties. These are comparable uncontrolled price, resale price, cost plus and other reasonable pricing methods. The comparable uncontrolled price method determines the price according to comparable transactions within unrelated parties-----independent parties, usually the market price; the resale price method requires the price at which the associated enterprise resells goods to unrelated third parties-----independent customers. The cost-plus method means cost plus suitable fees and profit. The mark-up is the cost-profit margin comparable to a similar transaction with an independent seller in the same industry. However, what constitutes "cost" in each of these cases remains unclear, since there are different concepts of cost, each of which will yield different prices.

All the above adjustment methods require comparable transactions. But it is difficult to find comparables in China. Most domestic companies are state-owned, and must comply with different laid down government policies. They would therefore not serve as good comparables. Multinational companies also transact businesses with related parties with no comparable transactions. Under such circumstances, alternative comparables from other Asian companies can be used as proxies. But the problem in adopting this approach is that it may not be easy to source reliable public data in China for this purpose. There is no information to assist the tax administrator to make effective and informed judgement. To obtain required information, both from China and abroad, a comparable database which contains performance measures of comparable companies and industries is required. This is only possible through international co-ordination and cooperation.

### 3.3.3. DOCUMENTATION AND PENALTY FOR NON-COMPLIANCE

The adjustment process for transfer pricing is full of details that are essentially trivial. In order to see whether the price between the FIEs and related parties is reasonable, auditors need adequate information, such as files relating



to business overview, organisational structure, pricing methods, controlled transactions, price comparables and economic analysis. Many countries have specific regulations of the requirement for effective transfer pricing documentation. In 1994, only one country had enacted transfer pricing documentation requirements. But other countries are expected to follow soon. By 2002, more than 20 countries had done so and this number is expected to continue to grow (ICC Policy Statement, 2003). Unfortunately, unlike these countries, there is no compulsory statutory requirement within the Chinese transfer pricing tax system for detailed documentation to be provided. Only contemporaneous documentation is requested. As a result, much of the auditors' time and effort are spent searching for information that would otherwise have been provided for audit and adjustment if provision had been a compulsory statutory requirement.

To ensure effective enforcement of tax legislation and regulation, many countries have set up transfer pricing penalties. They think these rules can prevent multinational companies from avoiding tax through transfer pricing. According to Ernst & Young's transfer pricing 2003 global survey, many respondents indicated being threatened by tax authorities through transfer pricing penalties. Parent companies complained that tax authorities in different countries were threatening to use their penalty powers in almost 29 per cent of cases in which an adjustment is determined. Penalties were finally imposed in 50 per cent of the cases threatened. But in China, there is hardly any specific transfer pricing penalty, except for a small fine of between RMB2000 (approximately USD 250) and RMB10,000 (approximately USD 1,250) for late declaration by the relative party. For any tax payable from a transfer pricing investigation or adjustment, the taxpayer must settle the payment within the time limit established by the tax authorities. Failure to do so attracts a surcharge of 0.05 per cent per day. In the event of serious violation, up to 5 times that amount can be imposed. Compared to other countries, the penalty for transfer pricing offences in China is rather light.

An understanding of special local features is necessary before borrowing and applying international transfer pricing experiences, such as "contrary tax-avoidance" to China.

#### 3.4. SPECIAL LOCAL FEATURE

Transfer pricing as a means of allocating revenues and costs between units of MNCs includes inter-company transfer of goods, property, services, loans and leases. The final outcome is normally a transfer of profit between segments of a multinational corporation in order to achieve strategic goals, avoid international tax globally and minimise various risks. Most MNCs regard transfer pricing as a useful tool for international tax avoidance achieved through shifting income from high to low income-tax-rate and expense from low to

high-tax-rate countries respectively, depending on different taxation systems and tax rates in the countries of operation.

But in China, conditions are quite different. As China is a developing country, the Chinese government has set up series of favourable taxation rules to attract more foreign investments. The efforts made in recent years have achieved fruitful results. China is now gradually becoming a preferred destination for more and more MNCs. Since the actual corporate income tax rate in China is rather low compared to most other countries, foreign enterprises should have no cause to shift income in order to avoid tax in China. However, the fact is that many FIEs in China, as earlier indicated, do engineer losses by buying high from, and selling low to, related parties in order to shift profit abroad. It is the special feature of transfer pricing in China – “contrary tax-avoidance”. Since such manipulations of profit result in high tax burdens for multinational companies, why do they follow it? FIEs in China engage in this practice because they regard transfer pricing as a convenient mechanism to repatriate money abroad without declaring dividend that would also attract income tax deductible at source. Joint ventures need not share profits with Chinese partners. The global profit of the multinational corporation would then be maximised despite the high total tax burden. This has resulted in the Chinese government receiving reduced tax revenue. Furthermore, and more importantly, it misrepresents China to the rest of the world as an unprofitable investment environment.

In suggesting how to solve these problems and improve the current transfer pricing tax system in China, international successful experiences have to be adapted to local realities. In doing so, we should follow the economic development trends in the rest of the world.

#### **4. SUGGESTED SOLUTIONS TO THE PROBLEMS**

##### **4.1. ADVANCE PRICING AGREEMENT (APA)**

Since 1998 when SAT issued the first comprehensive transfer pricing regulation, *Tax Administration Rules and Procedures for Transactions between Related Parties*, China has been taking steps to align its tax system with international practice. Another important milestone in the process of enforcing a transfer pricing tax system in China came in 2001. Since then, the tax authorities have been working relentlessly on the implementation rules of APA for business transactions between associated enterprises. APA is a formal agreement between the taxpayer and tax authorities prepared in advance, determining an appropriate transfer pricing method to be adopted for inter-company transactions. It is one of the mechanisms for minimising or resolving disputes between the taxpayers and tax administrations, which is especially useful when traditional approaches either fail or are difficult to apply (OECD 2001). After the formal application of APA in the United States in 1991, many countries

also decided to adopt it. APA, as a new trend in transfer pricing tax administration in the world, has been known to be both cost-saving and time-saving for audits. An APA procedure often has a seven-step: preparatory stage, submission of application, audit and assessment, consultation, signoff, monitoring and renewal.

Although more than 130 enterprises have so far signed APA with Chinese tax authorities, the process of accelerating the formal APA rules is rather long. For example, in 2002, the SAT issued the *Implementation Rules of Tax Collection and Administration Law*, which states that taxpayers may apply to the tax authorities for APA. Then in 2003, the SAT discussed the APA Implementation Rules further with MNCs and professionals. Public comments on the draft version were diverse. The final APA rules which were expected to be available in 2003 as the formal guidelines for APA in China were not published. Finally, after years of waiting and working, the formal APA rules in China were issued by the SAT in September 2004 as *Implementation Rules for Advance Pricing Agreement for related-party transactions*, comprising eight chapters of 33 articles and six procedures. These are pre-file meeting, formal application, examination and evaluation, negotiation, signing the APA, monitoring and execution.

It is true that APA is an internationally accepted solution to transfer pricing disputes. But during its operation in recent years in other parts of the world, there have been several problems. The two main problems are confidentiality and coordination between the taxpayer and the tax authorities. Such shortcomings are likely to be unavoidable in China's implementation of APA rules. For example, although the implementation rules have some articles about confidentiality, article 25 provides that both the tax authority and taxpayer should keep secret all the information obtained during the pre-filing, negotiation, examination and evaluation process. Furthermore, article 26 provides that if the final APA cannot be attained, non-factual information acquired during the process cannot be used for a later related audit. Meanwhile, there is no guarantee of confidentiality on the factual information, which can subsequently be used to audit the related party transactions. This could prevent more MNCs from applying APA in China. As regards coordination, it is an important function in China's situation. In China, there are tax authorities at both state and provincial levels. According to the Chinese law, while MNC applies APA, its multiple subsidiaries must negotiate separately with the local tax bureau. To simplify the problem, the new APA rules allow the direct coordination by SAT, especially when the case involves more than two provinces or the associated transaction is more than RMB 10 million (approximately USD 1.25 million). This stipulation encourages MNCs to use APA in China. But as WeiShu (2004) points out, because of inadequate resources within SAT, especially its anti-tax avoidance division, which has only four staff but is in charge of all transfer pricing matters in China, including APA, MNCs cannot have high expectations for its coordination. Since it is impossible to overcome

such difficulties within a short period of time, the world-wide application of APA is not promising. According to Ernst & Young's transfer pricing 2003 global survey, only 14 per cent of parents and 18 per cent of subsidiaries used APA. However, within those who have used it, 87 per cent of parents and 89 per cent of subsidiary companies would employ it again. It means the experience was positive if both sides - tax authorities and MNCs - develop the APA better. Statistics show there is a decline in the use of APA: 33 per cent of parents favourable in 2003, 38 per cent in 2001, 45 per cent in 1999. Based on the international application of APA, China should take a cautious attitude toward its practice.

#### 4.2. NEW CONTENTS

The 21<sup>st</sup> century is a new economics era. Three new economy dimensions of globalisation, knowledge and network have all developed so fast that the operation scope has changed significantly. The influences of intangible assets, services and e-commerce have replaced traditional goods. Since accounting theory and practice have virtually failed to keep pace with these new developments to measure them accurately, transfer pricing methods in MNCs cannot be expected to perform any better. Because of the very nature of intangible assets, services and e-commerce, determining their value objectively is difficult. When transactions related to them cross national borders, they create more problems for government tax authorities. The reality of the situation in China is that the transfer pricing tax system is at such a rudimentary stage that it tends to ignore transactions in intangible assets, services and e-commerce. To meet the challenges posed by these developments in China, new rules and regulations are required.

Although both OECD transfer pricing guidelines and United States regulations have detailed rules on intangible assets and services, there are difficulties in applying these rules. More research is needed to improve the legislations. In this regard, China should pay close attention to the latest international modifications. For example, the United States published a new action on September 10, 2003 calling for public comments on "Treatment of Services Under Section 482, Allocation of Income and Deductions from Intangibles" (IRS, 2003). The document includes proposed regulations which provide updated guidance reflecting the economic changes since the issue of the current rules. In order to preserve practical aspects of the current legislations, the one proposed has eliminated those aspects that had implementation problems. According to the publication, the new simplified cost-based method satisfies certain quantitative and qualitative conditions and requirements. It is also consistent with international standards in these areas. The purpose is to create less administrative burden on transfer pricing of intangible assets, services and e-commerce.

To improve the efficiency of the transfer pricing tax system in China, detailed documentation and penalty for non-compliance are necessary. Since the audit and adjustment on transfer pricing require a lot of information, many countries have included specific document requirements for multinational companies in tax law. The United States is an example of such countries. Extensive documents required include: business overview, organisation structure, methods selected, alternative method rejected, analysis of controlled transactions, identification of comparables, economic analysis, relevant data obtained after year-end and index. All the required documents must be submitted within 30 days of the request. But in China, there is no statutory requirement for documentation. It thus increases both cost and time of the audit and adjustment. To improve the current situation, there is need for more detailed rules which should include categories of relevant documents as well as deadlines for preparing and submitting this documentation.

To ensure integrity of the tax system, the Chinese tax authorities should strengthen and enforce penalty regulations to MNCs from shifting profits through transfer pricing. Current penalties are inadequate to check malpractices. There are no specific transfer pricing penalties except for late filing of related party transactions declaration which ranges from: RMB2000 (approximately USD 250) to RMB10,000 (approximately USD 1,250). Any tax payable from an investigation adjustment has to be settled within the time limit. In the event of any default, a charge of 0.05 per cent per day is imposed. Compared to international standards, the penalty is light. For example, in the United States, fines of 20 per cent to 40 per cent are imposed for underpayment of tax. The penalty is 15 per cent to 60 per cent in Norway; 20 per cent to 150 per cent in New Zealand; 70 per cent to 100 per cent in Mexico and up to 100 per cent in The Netherlands and the United Kingdom (Ernst & Young, 2004). So the penalty rules on transfer pricing tax legislation in China must be revised to fall in line with what exists in other countries.

#### 4.3. DATABASE AND COOPERATION

The audit and adjustment for transfer pricing of a multinational company call for the provision of relevant information. But in China, it is difficult to obtain reliable public information. It is therefore necessary to design a practical database from which to obtain the information required for the transfer pricing tax system. Such a database should contain comparables for adjustments, such as the market price of the same commodity in other countries and performance measures of parent companies and their subsidiaries. An “information system for administration of anti-tax avoidance” published by the SAT has been under trial operation in several major Chinese cities for the past 2 years. It has worked effectively so far, but some aspects require improvement before implementation in the entire country. For example, the sources for information are currently too limited. However, the SAT has recognised

the importance of comparability information in transfer pricing audits. In the new circular issued recently on the working requirements for anti-tax avoidance, the SAT has recommended information-sharing among tax bureaux (Circular 70, 2004). The anti-tax avoidance database (anti-tax avoidance information management system) is to have a trial run for a certain time period in 12 Chinese cities: namely Wuxi, Suzhou, Jinan, Yantai, Fuzhou, Guangzhou, Beijing, Tianjin, Dalian, Xiamen, Qingdao and Shenzhen. This calls for enhanced cooperation among different local tax authorities for anti-tax avoidance. Shared information includes statistics published by Customs officials, banks, government agencies and trade associations regarding prices of both tangible and intangible goods, service fees, debt interest, and profit margins at industry levels (ShuWei, 2004). Furthermore, besides coordination among the different levels of tax bureaux within China, China will require help from and cooperation with, international parties to acquire information about MNCs, as the transfer pricing transactions increase across borders of different nations. China may enter into more tax treaties with other countries exchanging the latest data.

As a complete transfer pricing adjustment requires assessment, comparisons, consultation and monitoring, the need for professionals is quite high. But in China, the level of expertise among transfer pricing tax officials varies from city to city. In the southern part where ShenZhen, for example, is the first Specific Economic Zone (SEZ) in the country and where FIEs have invested for many years, the local tax authorities have accumulated adequate experiences in monitoring. In large cities such as Beijing and Shanghai, where large MNCs operate, local tax officials are experienced and have been professionally trained to cope with transfer pricing audits. In small cities, the situation is less promising. To achieve the intended results, the operation of the system in big cities such as Beijing, Shanghai and Shenzhen, could serve as models for inexperienced tax officials to study and adopt. That is to say, the cooperation and coordination among different tax bureaux should involve more than just sharing of information, but should include sharing of experiences. Sometimes the exchange of ideas amongst professionals from different cities could prove useful in ensuring uniformity in effective management of the system. After 2~3 years of acquired experiences, the trained tax officials from other parts of China should be adequately proficient in both the theory and practice of transfer pricing tax system administration, making database design, training of officials and anti-tax avoidance application more effective than they are at present.

## 5. SUMMARY AND CONCLUSION

This study has critically examined the development of transfer pricing regulations in China for MNCs. Using those factors that influence the transfer pricing tax system, we analysed the problems of China's existing transfer pricing

rules, along with the changing trend of the policy evolution. Combining generally accepted international legislations with local features of the current situation, it proposes future policy options and suggests possible improvements for the Chinese tax authorities and government. Although it is a China-based study, other economies and potential foreign investors can also learn from the changing trends in China's transfer pricing policy-making.

Though this study has covered considerable aspects of the international transfer pricing system in China, it still has its limitations, especially in the fast developing Chinese economy and new rules issued recently. In practice, the SAT in China released the new circular and rule in 2004, both the *Notice on Further Strengthening Anti-tax Avoidance and Implementation Rules for Advance Pricing Agreement for Related-party Transactions*. These rules demonstrate that the SAT, especially its anti-tax avoidance division, is making great efforts in tackling transfer pricing anti-tax avoidance. But the result so far has not been satisfactory because of limited human resources that hamper effective performance of the task. For example, there are currently fewer than 300 anti-tax avoidance officials throughout China, conducting nearly 5,000 desk and 1,000 field audits every year (ShuWei, 2004). To save the time of these anti-tax avoidance specialists, Circular 70 identifies investigation targets in detail so that they can concentrate more on transfer pricing than other audits. The selection criteria for transfer pricing audit targets are: 5 per cent of long-time loss making FIEs, 3 per cent of low profit/loss FIEs which continuously expand their operation scales and 2 per cent of fluctuating profit-making FIEs. Furthermore, the SAT and the Ministry of Finance are currently drafting a new unifying corporate income tax law, in which the new transfer pricing rules will be renewed according to practical requirements. It also presents the new research direction for transfer pricing in China.

One important area of further research is the effectiveness of the new regulations on transfer pricing. It will also be necessary to investigate the impact of intangibles on transfer pricing of MNCs operating in China.

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*For Journals:*

Kornai, J. (1993), The Evolution of Financial Discipline under the Post-Socialist System, *Kyklos*, 46(3), 315-336.

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Bonin, J. P. and M. E. Schaffer (1995), *Banks, Firms, Bad Debts, and Bankruptcy in Hungary 1991-94*, CEP Discussion Paper No. 234, London: Centre for Economic Performance at LSE

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CATO Institute (1998), *Rita Gluzman, Petitioner v. United States of America, Respondent, Brief of Amicus Curiae the Cato Institute in Support of the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit*, <http://www.cato.org/pubs/legalfbriefs/gluzman.pdf> [accessed 15th March 2001]

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Revenue, R is calculated as

$$R = P \times V \quad (1)$$

where

- P is the selling price, and
- V is the volume of sales in units.

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