

financial stability? (Verdier's view seems to be that the current pace of disintermediation makes his story about nineteenth century competition over resources by core and periphery banks less relevant for understanding the future.) Since it examines the present as well as the past, it would have been nice if the book could have considered in more detail how the movement to harmonize banking regulations across countries (Basle I and II accords) is altering the shape and structure of national banking systems.

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The Size of Nations. By Alberto Alesina and Enrico Spolaore. Cambridge and London: MIT Press, 2003. Pp. x, 261. \$35.00. ISBN 0-262-01204-9. JEL 2004-0146

This book is a highly creative and lucid analysis of the determinants of the number and size of nations by the leading economists in the field. It encompasses both theoretical modeling and empirical evidence, and the discussion ranges from the European city-states of the thirteenth century, through the colonial empires of the twentieth century, to the modern-day European Union. The book is a tour de force. It stands as an outstanding example of how the rigors of economic analysis can be applied to new fields and of the insights to be gained from elegant and tractable formal models.

The nation-state is defined in terms of a monopoly of coercion and the legal use of force within its boundaries. The central tenet of the book is that the size of nations is determined by a trade-off between the benefits of economies of scale in providing public goods (e.g., defense) and the costs of heterogeneity in preferences over the provision of these public goods.

This raises the question why, instead of a unified nation-state, we do not observe a series of overlapping jurisdictions that best resolve this trade-off for individual public goods. The authors argue convincingly that such a configuration would face prohibitive transactions costs and fail to internalize economies of scope. The nation-state monopolizes the provision of essential public goods (law and defense), and adopts a host of other functions because of economies of scope

and transaction costs. Some functions are delegated to subnational levels of government, but subnational jurisdictions do not cross national borders.

The book highlights a number of considerations that shape the way in which the trade-off between economies of scale and heterogeneity in preferences is resolved. One is the political regime. Dictators will choose larger states than democracies because they can extract larger total rents from larger populations. One of the important predictions of the analysis is, therefore, that democratization will be associated with political separatism and the breakup of large countries. This resonates with the experience of the former Soviet Union and the post-World War II period as a whole. A further finding is that democracy may not yield the socially optimal number and size of countries because people who are ideologically or geographically far from the center may have an individual incentive to secede. Whether the social optimum is attained under democracy depends on the feasibility of transfer payments.

Another consideration is the trade regime. Economies of scale imply that, under autarky, there is an economic advantage to being a large country. In contrast, under free trade, a country's market size is independent of its political size, and small countries may prosper. Thus, another noteworthy prediction is that economic integration should go hand in hand with political disintegration. In their historical overview, the authors argue that this is consistent with the experience of the protectionist interwar period, when few nations were created, and the trade liberalization of the post-World War II period, when many new countries came into being.

The international military climate also plays a role. If there are economies of scale in the provision of defense, a more bellicose world tilts the trade-off between economies of scale and heterogeneity costs toward the former, so that countries will tend to be larger and fewer in number. A further prediction of the analysis is, therefore, that a more peaceful world should lead to political separatism. Again this is consistent with events since the end of the Cold War. For a given probability of conflict between any two nations, an increase in the number of countries raises the expected number of conflicts, perhaps explaining why the post-Cold War "peace dividend" has been smaller than anticipated.

The authors examine issues of federalism and decentralization, as well as the role of supranational organizations such as the European Union. The trade-off between economies of scale and heterogeneity costs provides a framework for examining which public goods should be provided at various levels of government. Decentralization may be a response to political separatism in order to keep the nation-state intact.

As the authors themselves state, the book is not meant to be the definitive word on the subject, but is intended to open up novel areas for research and ask more questions than it answers. More empirical evidence on the economies of scale in the provision of various public goods would be welcome, as would more evidence on the role of size in determining prosperity and on how this depends on the degree of economic integration. As discussed in the book, variation across subnational units within countries may provide an important source of identification.

There are links with a variety of other economic literatures that seem open to fruitful further research. These include work on the microeconomics of sorting and segregation. Also relevant is the economic geography literature, which endogenizes the distribution of income and people across space, but typically takes country size as given. There are a number of issues of political economy that could be explored further. How is the quality of domestic institutions and external trade policy determined jointly with country size? What is the role played by vested interests? How does this interact with the process of economic development?

What is clear is that this outstanding volume makes path-breaking contributions and lights the way toward a rich seam for further research.

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Saving Social Security: A Balanced Approach. By Peter A. Diamond and Peter R. Orszag. Washington, D.C.: Brookings Institution Press, 2004. Pp. viii, 287. \$32.95. ISBN 0-8157-1838-1. JEL 2004-0553

Peter Diamond and Peter Orszag have produced an important book offering an objective assessment of Social Security's financial outlook and a plan to restore its long-term solvency. Their proposal has the important advantage of honesty—it is a comprehensive package of benefit

cuts and tax increases that actually would fix the problem. There are no tricks and no free lunches. Anyone who reads the book carefully will come to understand the rather complicated U.S. Social Security system, how we got into the current situation of projected shortfalls, and the details of a particular plan to fix it. While I don't agree with all aspects of the authors' prescription, their plan merits serious economic and political consideration.

The authors proclaim in their title and repeatedly in the text that theirs is a balanced approach. It is in one sense. The Diamond-Orszag plan relies roughly equally on cutting benefits and raising taxes to achieve long-run financial stability. In another way, however, the plan is not balanced. The big debate over the last twenty years regarding Social Security is whether the system should remain a defined benefit system (with benefits determined by formulas) or whether we should switch to a defined contribution system (usually termed "individual accounts"). In this debate, Diamond and Orszag are firmly in the defined benefit camp. They want to keep the basic structure of the system intact. I favor a two-tier or "some of each" approach and would characterize such two-part proposals as more balanced.

Diamond and Orszag concentrate on three reasons why Social Security is in need of significant reform. First, there is the good news of dramatically increasing life expectancies. That may be good news, but it imposes financial problems on a system providing inflation-indexed life annuities. Second, they list increasing earnings inequality. And, third, they consider the legacy costs of the extraordinary deal that Social Security offered the first couple of generations of participants. Each of these factors causes the authors to propose adjustments in legislated benefits (mostly cuts) and payroll tax rates (all increases). The whole menu of adjustments is pretty sobering—but any plan that restores long-term solvency must have a comparable list of tough provisions.

The Diamond-Orszag plan can be characterized as a "soak the rich" proposal. This isn't particularly surprising given their concern with increasing inequality. For instance, they would introduce a new 3 percent payroll tax applying only to earnings above the Social Security cutoff, currently \$87,900. This tax would be over and