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cial role of the government, is how the bureaucrats in charge remained immune from corruption. Recent evidence suggests more corruption than hinted at in the book, but it is still small by the standards of other developing and transforming economies. One wonders then whether the earlier documented virtues of the system can be replicated in other countries. For instance, Bhatt argues the lead bank system in India was far less successful, even though the system was designed with similar intent. Why did it not work in India? Was it because of excessive government interference or less competent and more venal bureaucrats in India? If so, how should developing countries guard against this? Finally, the book, while documenting the value of banks when an economy has young and growing firms, also hints at the opposition banks pose to liberalization when firms become mature enough to tap the markets themselves. Will the transition to a more market based form of finance be delayed if banks are given too much power when an economy is young? If so, how should the resulting costs be weighed against the benefits of the system? While these questions all suggest more research before the Japanese system is advocated for other economies, the authors in this book have done a splendid job in educating the reader about it.

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The prudential regulation of banks. By MATHIAS DEWATRIPONT AND JEAN TIROLE. Translation. Walras–Pareto Lectures, vol. 1. Cambridge and London: MIT Press, [1993] 1994. Pp. xii, 262. $25.00. ISBN 0–262–04146–4.

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After the Savings and Loans debacle and the solvency problems of banks in a host of countries the book by Dewatripont and Tirole comes to illuminate the thorny issues associated with the prudential regulation of financial institutions using an insightful and coherent analysis.

The authors argue that the main goal of regulation is the protection of small depositors and that the main tool to accomplish it is to bring about an efficient corporate governance structure for banks. According to Dewatripont and Tirole the distinguishing feature of banks is that their debt is held by small investors who are not able or willing to monitor banks' activity. Hence, depositors need to be represented by a public or private agent. Aside from this, banking regulation must deal with essentially the same issues that arise in connection with the control of firms by large creditors.

The starting point of Dewatripont and Tirole is to consider a bank as a managerial firm. Then, they confront the challenge of explaining why the capital structure of banks, that is, their solvency or debt/equity ratio, matters from the point of view of a manager's performance. Indeed, we know from the Modigliani-Miller theorem that if complete contracts between owners and managers could be written then financial structure would be irrelevant. To get around this the authors turn to the incomplete contract paradigm to build their model.

A key assumption is that external intervention, which is crucial to affect managerial incentives, is "noncontractible." The view is that the incentives that can be offered to managers are limited by problems of verifying the bank's performance. Dewatripont and Tirole's basic model is extremely simple. They consider a manager whose unobservable effort affects the quality of the bank's loan portfolio and whose only objective is to preserve the private rents (perks and so on) of staying in the job. Furthermore, the party who has control over the bank (be it shareholders or debtholders), can choose only between a risky "continue" and a conservative "stop" action (involving possibly a reorganization, cancellation of projects, . . .). Efficiency then requires that there should be more interference with management when the (verifiable) performance of the bank is poor. The optimal managerial incentive scheme can be implemented in a variety of ways, including contingent control mechanisms, net worth adjustments, and a recapitalization scheme. The basic idea is always the same: When performance is good, control should stay with shareholders who have a tendency to be "passive"—that is, to continue with the risky course. This is so because shareholders have a convex return structure due to limited liabil-

ity. When performance is poor, control has to change to debtholders/depositors, who have a tendency to be "interventionist," that is, to choose a conservative course for the bank. This is so because this group has a concave return structure. The threshold for the change in control can be interpreted as a minimum solvency requirement. This can be complemented with recapitalization following a bad performance and an extra allowance for dividend distribution when performance is good.

These ideas constitute the core of the book and are nicely presented in Part III. Before that, Part I provides a truly remarkable description of banking regulation institutions with particular attention to the Basle Accords (1988) and U.S. regulations. This part also includes a description of the U.S. S&L crisis. Part II contains background material on some theoretical models of banking and an outline of the main argument. Part IV of the book contains the application to regulation of the ideas developed in Part II. It provides a penetrating analysis of the strengths and weaknesses of the Basle Accords, and discusses also the role of securitization, the political economy of regulation, and the tradeoffs associated with private remedies such as rating agencies, private deposit insurance, and the role of uninsured subordinated debt. The implications for regulatory practice are gathered in Part V. The authors conclude that market value accounting should be introduced when feasible, with net worth adjustments to compensate for macroeconomic shocks, that solvency measures should take account of interest rate and market risk, and not only credit risk (which should be handled at the portfolio level), and that private rating agencies should be used with caution. Furthermore, it is argued that a broad deposit insurance system is preferable, and that the Basle Accords on solvency roughly approximate the optimal governance structure except that account should be taken of macroeconomic shocks. In good times they should be offset with dividend distributions and in bad times with recapitalization complemented perhaps with a subsidy scheme.

All this makes good economic sense and some recommendations coincide with those derived from other approaches to banking regulation like the classical portfolio approach. In this sense it would have been nice if the authors had devoted some more space to contrasting their recommendations with the received results in the literature.

Both the strength and the weakness of the book lie in its adoption of a definite point of view. According to the authors the prudential regulation of banks is a matter of finding the optimal governance structure in a context where depositors need to be represented (and protected). The advantage of the approach is that it provides a coherent framework, based in incomplete contract theory, in which to understand regulation (and this is exploited magnificently by the authors). A disadvantage is that it obviates a (and for some *the*) major concern of banking regulation: systemic risk and the preservation of the stability and smooth functioning of the banking and payments system. On the methodological front, the model presented by the authors is very streamlined and several aspects of it may be open to question. However, it must be acknowledged that, as of today, there is still no well established foundation for why contracts may be incomplete and therefore the assumptions made by the authors are not uncommon in the literature.

All in all this book has more than accomplished its self-imposed task of contributing to the foundations of a theory of regulation of financial intermediaries. The book is a must both for academics and for practitioners interested in the prudential regulation of banks.

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H Public Economics

Public economics in action: The basic income/flat tax proposal. By ANTHONY BARNES ATKINSON. Lindahl Lectures series. Oxford and New York: Oxford University Press, Clarendon Press, 1995. Pp. xiii, 169. $35.00. ISBN 0–19–828336–9. *JEL 95–1572*

This excellent book is based on a series of lectures in honor of Erik Lindahl, given by Professor Atkinson in 1989 at the University