Prologue

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Globalization has meant the closer integration of countries, and that in turn has meant a greater need for collective action. The book provides one of the first systematic treatments of public finance for the new era of globalization—with the totally appropriate title *The New Public Finance.*

Over the years the focus of public finance has changed dramatically. At one time it was strictly about what the term proclaimed—how governments should raise money to finance public activity.[1] By the time I began teaching the subject, in the 1970s, it had been redefined to *The Economics of the Public Sector* (the title of the text I first published in the early 1980s; Stiglitz 1986), giving equal weight both to expenditures and taxation. Macroeconomics was left out—not because it wasn't an important area (and earlier texts by Richard and Peggy Musgrave had included the subject) but because the subject had to be circumscribed somehow.

A half century ago Tiebout (1956) opened up the formal study of competition among communities, which I expanded in a paper delivered in 1974 into the general theory of local public goods (Stiglitz 1977), goods whose benefits accrued only to people living in a particular community. Public finance differed fundamentally when factors (labor and capital) could choose where to reside from when factors were not mobile. In the extreme, there was no scope for redistribution (Stiglitz 1986a,b)—a subject that had been at the center of traditional public finance discourse.

The new public finance at the time had to deal with the interplay between national and local public finance, including what activities should be conducted at the national level and what at the local level. It was clear that national public goods, for instance, ought to be provided at the national level, and that responsibility for redistributive taxation also must lie there.

As we move further into a globalized world, analogous issues are again being raised. With increased mobility of factors, redistribution may become more difficult. Having formalized the concept of local public goods, it was natural to extend that to the concept of *global public goods,* goods whose benefits accrue to anyone living anywhere in the world.[2] It would make sense for responsibility for the provision of such goods to rest with a global authority. And yet there is no global body able to meet the needs for global collective action and to organize the provision of global public goods.

This makes the challenge of the new public finance all the greater. There is no pristine theory and no set of well functioning institutions reflecting a common understanding of the role of collective action. There are myriad challenges:

national authorities now must take into account the outside world as they formulate their tax and expenditure policies. With footloose firms, they must worry about how tax and expenditure policies affect the competitiveness of investments in their country.

Financing global collective action is particularly problematic. In the past, for instance, the United Nations has been financed mainly by "dues." The only enforcement mechanism is expulsion from the "club." More recently, however, a number of governments have put on the table a set of innovative proposals, from taxes levied on certain cross-border transactions, to revenues raised from managing global public resources, to income derived from creating a new global currency to replace the current reserve system.

The *New Public Finance*, of course, does not deal with public finance alone, narrowly defined, but with a host of concerns requiring global collective action. In response to the need for collective action, we have developed a system of global governance without global government, a patchwork of institutions and agreements, varying in the effectiveness and efficiency with which they deal with the needs for collective action within their purview. Understanding these *public* failures is no less important than understanding market failures. Just as political economy has become an important part of standard public finance at the national level, so too should it be at the international level. Regrettably, this remains a very underdeveloped area of research.

As a result, international organizations often miss correcting serious market failures—and sometimes even compound them through their actions. Capital market liberalization has been actively promoted and arguably has exposed developing countries to increased risk. Well developed financial markets would presumably shift the burden of that risk from those less able to bear it (the poor) to those better able to do so. But there is massive market failure, with enormous consequences. This is a market failure that the International Monetary Fund and other international organizations should have long ago addressed, but which, as the book shows, is only now emerging as a policy focus.

Still another problem that should have been addressed but that has been allowed to linger is the global reserve system, a system that imposes enormous costs on developing countries, exerts a deflationary bias on the global economy, and contributes to global instability. The dollar reserve system not only has not worked, but it is quickly fraying, as central banks around the world increasingly move out of dollars. The multiple reserve currency system that is evolving, however, does not promise to be much more stable, or any more equitable, than the current system. There are alternatives, including regular emissions of Special Drawing Rights, that need to be considered.

One of the most important areas of market failure is the environment. Without government intervention, firms and households have no incentive to limit their pollution. The new public finance is concerned with *global* externalities—in this case, global environmental problems, the most important being global climate change. Just as a standard topic within traditional public finance is the evaluation of alternative ways of "correcting" these market failures, so too here. The international community, through the Kyoto Protocol, has settled on a particular remedy—tradable permits. But this has involved difficult problems of assigning pollution rights. And while it is remarkable that so many countries have signed on to the protocol, with the largest polluter, the United States, refusing to sign, and with no commitments from developing countries—of increasing importance in greenhouse gas emissions—it is not clear that this approach will work. Alternatives, including common measures (an agreement, say, on common levels of taxation), entailing fewer redistributive issues, should be explored.

There are some areas where new institutional arrangements are clearly needed. One, dealt with here, is sovereign debt restructurings, a topic (bankruptcy) that at the national level traditionally falls under the rubric of industrial organization and policy. And yet the issues are so central to global public finance that they rightly belong here.

One of the most important issues in both the old and the new public finance is how to provide assistance. The old public finance debated questions of matched grants or lump sum aid. The new public finance debates issues of development assistance, of loans or grants to developing countries, of how to enhance private sector participation, and of the role of conditionality, among others.

It is a rich landscape: redefining the vast subject of public finance in ways that respond to global challenges. It entails revisiting virtually every topic that has been discussed within the old public finance, plus some that have not. The book is a landmark—it provides the important beginnings of a field that will be tilled for years to come.

Notes

1. Though the classic text of the mid-twentieth century, Musgrave and Musgrave (1989), did devote some attention to public goods.

2. Since I first developed the concept in 1995, the literature has blossomed. See, for instance, Kaul, Grunberg, and Stern (1999) and Kaul and others (2003). See also Stiglitz (1998).

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