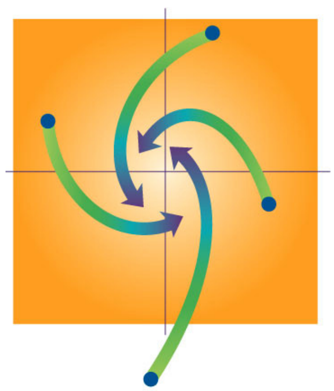
Blending External and Domestic Policy Demands

The Rise of the Intermediary State

by

Inge Kaul



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Inge Kaul

Public finance theory seems largely to assume the continued existence of the ideal-type Westphalian state with exclusive political authority within its geographic boundaries based on territorial and policymaking sovereignty. The state is an aggregator of national preferences concerning government interventions that are deemed to be potentially desirable, especially where market failure arises. To ensure that established policy priorities can be implemented, the state is also said to enjoy unique coercive powers.

This model of the state is increasingly at odds with reality. As states face an ever-denser network of external expectations too desirable or too costly to ignore, they respond with corresponding national policy reforms. As a result, their role has been changing. The Westphalian state has progressively transformed itself into an intermediary state—blending domestic and external policy preferences, correcting markets and standing corrected by nonstate actors (business and civil society), exerting coercive powers and being compelled to compete with other states for mobile resources (finance and skills). Exclusive national policymaking sovereignty has given way to responsive policymaking sovereignty.

This chapter explores the rise of the state as intermediary. Following a brief elaboration of the model of the state underpinning mainstream public finance theory, the chapter examines the external policy expectations facing the state: how and by whom they are formulated, what they require, and what their objectives are. States' responses to these expectations are then considered, setting the stage for a discussion of how states' acceptance of an intermediary role between external and domestic policy demands affects their role. The chapter points to discrepancies between the state's role in public finance theory and in actual policy practice and identifies areas in which public finance theory might need to better reflect the new, broadened role of the state.

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The model of the state in public finance theory

As Desai (2003), Musgrave (1969, 1998), and others have noted, the role of the state has changed throughout history, and with it public finance and economics theory. During the twentieth century the state in most parts of the world played a strong role, still echoed in much of today's public finance theory. Especially in response to the Great Depression of 1929 and the devastation of World War II economic reality and theory emphasized active government intervention to accelerate reconstruction and stimulate economic growth. Keynesian ideas informed much of this policy approach in the Western industrial countries. A strong state and control of cross-border economic activity were also favored by many developing countries, for reasons of nation building, import substitution, and at times rent-seeking by the ruling elites. Of course, the state also reigned supreme in the former socialist, centrally planned economies.

The role of the state in both theory and practice started to change noticeably around the mid-1970s. The image of the state as a benign, paternalistic institution began to be queried (Chang 2003). Public choice theorists (such as Buchanan and Tullock 1962) developed a more nuanced concept of the state, depicting politicians and bureaucrats as self-interested actors pursuing private as well as public agendas. Principal-agent theories of bureaucracy (for example, Niskanen 1973) contributed to the debate, pointing to a growing state apparatus and arguing that state agents are more the masters of the public than their servants.

As markets deepened and expanded and gradually integrated across countries, and especially as the East-West divide vanished, the debate about market versus state gathered momentum. The policy pendulum swung toward markets, advocating privatization and economic liberalization.[1]

Mainstream public finance literature adapted. Textbooks typically identify three core elements of the state.[2] First, the state is the aggregator of national policy preferences. National political processes define the policy initiatives to be undertaken by the state and the corresponding budget. Many public finance textbooks devote considerable attention to preference revelation and other political economy issues, including voting rules and the incentives of politicians and bureaucrats, which may give rise to government failures. Although problems have been recognized (Arrow 1963), this parceling together of national policy demands is a recognized key role of the state.

Second, in line with the rebalancing of markets and states that began in the mid-1970s, leaving the provision of goods and services to the market has become the default scenario. The state's role is mainly to correct market failure and to promote desired levels of societal or intergenerational distribution where market outcomes deviate from those levels.[3] These roles are usually referred to as the state's allocation and distribution activities (Musgrave and Musgrave 1989).[4]

Third, the state enjoys unique coercive powers, including regulation and taxation. Drawing on its coercive powers, the state imposes taxes and collects other revenue to pay for planned public expenditures and puts in place other measures (typically regulatory) required for society to realize its established policy goals. These powers allow states to foster collective action by keeping free-riding in check and making all contribute their share to the costs of general administration and to the policy interventions defined under its role as aggregator of policy preferences (say, in support of a public good such as national security or a distributional effort such as social protection).

The underlying model described by these three core elements is still essentially that of the Westphalian state: a state enjoying *exclusive* political authority within its territorial boundaries. For the most part public finance and public economics textbooks still assume a closed economy. While some mention cross-border spillovers and global public goods issues (especially global environmental challenges), few treat these concerns systematically (Sidikou-Sow 2005).

Reality is increasingly at odds with this model. States are facing an ever-denser international network of external expectations about their national public policy, and they are, in large measure, complying with them, as the next two sections show.

External expectations about national public policy

Ideas about desirable state behavior are being discussed in numerous forums. Whether ultimately agreed on or not, many of these ideas become part of the pool of external expectations about desired national public policy and part of the international policy domain that Ruggie (2004, p. 519) describes as:

> *constituted by interactions among non-state actors as well as states. It permits the direct expression and pursuit of a variety of human interests, not merely those mediated (filtered, interpreted, promoted) by states. It "exists" in transnational non-territorial spatial formations, and is anchored in norms and expectations as well as institutional networks and circuits within, across and beyond states. . . .*
>
> *The effect . . . is not to replace states, but to embed systems of governance in broader global frameworks. . . .*

But what are these expectations? What are their origins and forms? And what is their purpose?

Origins and forms of external policy expectations

Policy expectations can be considered external when they emanate from outside the national political processes through which states ascertain and aggregate domestic policy demands. The origin (rather than the substance) matters when identifying a policy demand as external or domestic. External sources of policy expectations include intergovernmental forums, international business and civil society organizations, global media, and multiactor venues like the World Economic Forum.[5] Thus all actor groups—states (individually, as "clubs," or multilaterally), business, and civil society—are involved in formulating global policy visions and demands.

External policy expectations have proliferated since the 1990s so that it is now virtually impossible even to guess at their number. Undoubtedly, it is huge—and rising. Approximately 2,000 multilateral treaties are registered with the United Nations,[6] along with (perhaps thousands of) major international conference resolutions and plans of action that are not treaties but that demand follow-up. Add to this the more than 2,000 bilateral investment treaties (UNCTAD 2004), some 250 regional trade agreements (WTO 2005), and policy statements by the 60,000 or so international civil society organizations (Anheier, Glasius, and Kaldor 2004, p. 320), and the vast number and diversity of international expectations about national public policy become evident.

External policy expectations have also grown in the attention they command. The follow-up to global policy norms is ever more closely monitored, and many norms come with carrots and sticks. For instance, there are now more than 100 global reports prepared by intergovernmental, global business, or global civil society organizations that track major trends and policy achievements at the international as well as the national level (Haller 2005). In addition, numerous country reports review compliance with various global norms and standards. An example is the series of Reports on the Observance of Standards and Codes undertaken by the International Monetary Fund at countries' request.[7] Clearly, national public policy is subject to ever-closer scrutiny.

In addition, external expectations are increasingly taking the form of policy conditionality. For example, the number of conditions accompanying International Monetary Fund loan programs rose from 6 in the mid-1970s to 20 and more in recent years (Kapur 2001, p. 216).[8] Some stipulations touch on such policy issues as privatization and economic liberalization, which are not always directly linked to the borrowing government's repayment capacity. Foreign aid, too, is increasingly dependent on compliance with donor policy priorities, including respect for human rights, economic and financial liberalization, control of money laundering, and other political commitments (Raffer 2004). Similarly, credit rating agencies usually consider criteria that reflect external policy expectations and that have immediate financial implication, thereby enforcing the "discipline of the market" by determining the price at which national actors can borrow on financial markets.[9]

In addition to sovereign credit rating agencies there are approximately 130 composite indices and scorecards that measure and rank country performance and state behavior (Bandura 2005b). All actor groups are engaged in these "beauty competitions" among states—civil society organizations like Third World Network/Social Watch and Transparency International, policy think tanks like the Center for Global Development, private entities like the Economist Intelligence Unit and AT Kearney, and intergovernmental agencies like the United Nations Development Programme and the World Bank.

Thus, international public policymaking is an increasingly busy process, with multiple actors heaping layer upon layer on to the global stockpile of policy norms and, most important, expecting in ever more demanding terms that states will accept them as guideposts of national policymaking.

But what is all this ferment about? What are states actually expected to deliver in terms of national public policy reforms and outcomes?

The contents of external policy expectations

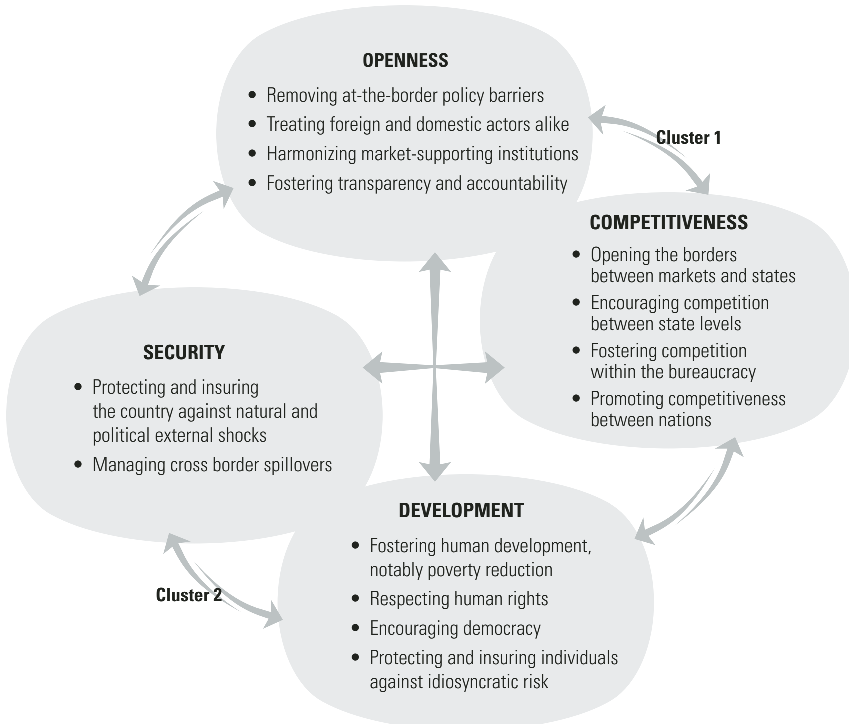
A pragmatic approach to answering these questions is to assume that all these indices and scorecards represent a codification of the most important external policy expectations and then to catalogue the dimensions of state behavior that they try to capture.[10] This exercise shows that external policy expectations fall into two main clusters, with two parts in each (figure 1)[11]:

- Cluster 1: Openness and competitiveness.
- Cluster 2: Development and security.

Cluster 1 reflects largely the interests of transnational business actors, while cluster 2 echoes the concerns of civil society and development advocates, including many bilateral and multilateral aid agencies. Yet there are no clear dividing lines between the clusters' constituencies. Individual firms and business associations can support basic education and public health services, because they recognize that such spending is a good investment in human capital and good for the company's reputation and, ultimately, its bottom line (Benioff and Southwick 2004; Dawkins 2002; Roman, Hayibor, and Agle 1999). And civil society and intergovernmental organizations increasingly stress the role of markets in pursuit of their aims, realizing that even such challenges as poverty reduction are often best met through private entrepreneurship (see, for example, Commission on the Private Sector and Development 2004 and World Bank 2004b).

Cluster 1: calls for economic openness and competitiveness. Cluster 1 expectations espouse a multilayered notion of economic openness plus the recognition that openness calls for a capacity by state and national nonstate actors to compete—lest the country fall behind others on the global competitiveness ladder (see box 1 for evidence on the dimensions under which openness and competitiveness are measured and monitored). To increase economic openness, recommended policy reforms call for: removing at-the-border policy barriers, treating foreign and

FIGURE 1
Clusters of external expectations about national public policy



domestic actors alike, harmonizing market-supporting institutions, and fostering transparency and accountability. To boost competitiveness, reforms call for opening the borders between markets and states, encouraging competition between state levels, fostering competition within the bureaucracy, and promoting competitiveness between nations.

At-the-border issues related to improving global welfare, such as the removal of trade taxes and quotas and the lifting of capital controls, continue to be important concerns—witness the current Doha Round of multilateral trade negotiations.[12] A recent study estimates that without knowledge-related spillovers, world gross domestic product (GDP) would stand at only 6 percent of its current level—$3 trillion, the same as it was about 100 years ago—instead of $50 trillion (Klenow and Rodriguez-Clare 2004, p. 44).

However, the demands for economic openness also touch increasingly on behind-the-border issues. States are urged to abandon policies that interfere with market operations and prices by giving domestic actors an undue advantage over foreign competitors. The calls for removing export subsidies that support

Box 1

SELECT INDICES OF ECONOMIC OPENNESS AND COMPETITIVENESS

More than 60 indices seek to measure country performance and state behavior in terms of economic openness and competitiveness, as defined in this chapter. They measure the aspects of national public policy without which market integration, and so globalization, might not succeed. The following partial list of indices and their creators illustrates the range of topics they cover:

- Bribe Payers Index (Transparency International)
- Capital Access Index (Milken Institute)
- Corruption Perception Index (Transparency International)
- CSGR Globalisation Index (Warwick University)
- Ease of Doing Business (World Bank)
- Economic Freedom of the World Index (Fraser Institute)
- E-Government Index (World Markets Research Centre and Brown University)
- E-Government Readiness Index (United Nations Online Network in Public Finance and Administration)
- EIU Business Environment Rankings (Economist Intelligence Unit)
- Emerging Market Bond Indices (JPMorgan)
- E-readiness Ranking (Economist Intelligence Unit)
- Foreign Direct Investment Confidence Index (AT Kearney and Global Business Policy Council)
- Foreign Direct Investment Indices: Inward FDI Performance Index, Inward FDI Potential Index and Outward FDI Performance Index (United Nations Conference on Trade and Development)
- G-Index (Globalization index) (Foreign Policy and AT Kearney)
- G-Index (Globalization index) (World Markets Research Centre)
- Global Competitiveness Index (World Economic Forum)[a]
- Global Investment Prospects Assessment (United Nations Conference on Trade and Development)
- Global Retail Development Index (AT Kearney)
- Governance Indicators (World Bank)
- Index of Economic Freedom (Heritage Foundation and Wall Street Journal)
- Innovation Capacity Index (World Economic Forum)
- International Country Risk Guide Ratings (PRS Group)
- Networked Readiness Index (World Economic Forum)
- Offshore Location Attractiveness Index (AT Kearney)
- Opacity Index (Kurtzman Group and PriceWaterhouseCoopers)
- Overall Market Potential Index (Michigan State University)
- Quality of Workforce Index (Business Environment Risk Intelligence)

Box 1 Continued

Select indices of economic openness and competitiveness

- Sovereign Credit Ratings (Standard & Poor's)
- Sovereign Credit Ratings (Moody's)
- Sovereign Credit Ratings (FitchRatings)
- World Competitiveness Scoreboard (International Institute for Management Development)

a. The World Economic Forum has historically presented two indices in its annual *Global Competitiveness Report:* the Growth Competitiveness Index and the Business Competitiveness Index. Since *Global Competitiveness Report 2004–05,* however, the two indices have been consolidated into the more comprehensive Global Competitiveness Index.
Source: Bandura 2005b.

domestic producers in international markets are a case in point. In addition, states are being held to the principle of nondiscrimination between foreign and domestic market actors.[13]

Another dimension of behind-the-border economic openness is the expectation of harmonizing market-facilitating state institutions. Such ingredients of a good investment climate as a sound legal system that protects property rights (ensuring against expropriation), norms and standards for banking regulation and supervision, adequate accounting and auditing procedures, corruption control, and enforcement of competition and antitrust policy are expected to be strengthened and brought in line with international practices of good governance.[14]

Demands for harmonizing institutional infrastructure are complemented by demands for harmonizing physical infrastructure to facilitate international transport and communication. Harmonization lowers information and search costs. Similar concerns with reducing transaction costs prompt calls for transparency of government policy and government commitment to such policy principles as inflation targeting and currency convertibility.

There is broad recognition that once states increase economic openness, they need to enhance their capacity to compete along with the capacity of firms and workers residing in their territory. Thus, states are urged to foster innovation that improves productivity and economic competitiveness (Porter and others 2004a). And the indices and scorecards of state behavior and performance hold up a mirror to states, enabling governments and nonstate actors to see how well they meet expectations—relative to the performance of other states.

For the state apparatus itself external policy expectations suggest the erosion of conventional dividing lines between markets and states, private and public sectors, in search of enhanced economic efficiencies. This includes opening up the financing and delivery of government programs to competition from private for-profit or nonprofit firms and engaging in public-private partnering through, for example, outsourcing or contracting out. Governments are also expected to foster decentralization and competition among state agencies.[15]

Without the capacity to compete, countries are likely to jeopardize their economic growth and development. As Wolf (2004, p. 277) notes, "failed states, disorderly states, weak states and corrupt states are shunned states—they are the black holes of the global economic system." However, the inability of some countries to compete successfully also reflects negatively on globalization's claim to benefit all. Thus, being able to compete is not only important for each country individually but for the integrity of the world economic system. Not surprisingly, there are several competitiveness indices and country rankings, all spurring countries to enter, stay, and succeed in the global competitiveness game (see box 1).

Cluster 2: calls for development and security. Globalization's record is checkered. Many analysts agree that it has opened new opportunities. However, as Ocampo and Martin (2003) point out, what comes to mind in describing recent economic trends are such terms as "crisis," "volatility," "risk," "contagion," "inequity," and "insecurity." Cluster 2 expectations are intended to correct these failures, to provide development and security "cushions" (Kapstein and Milanovic 2002) that permit economic globalization to proceed (see box 2 for efforts to assess and monitor how countries fare in respect to these dimensions). To advance development, analysts recommend fostering human development (notably poverty reduction), respecting human rights, encouraging democracy, and protecting and insuring individuals against idiosyncratic risks. For improving security, they recommend protecting and insuring the country against natural and political external shocks and managing cross-border spillovers.

Democratic and participatory governance and the realization of basic human rights increasingly form part of the set of development-related expectations (see, for example, Amnesty International various years, Freedom House various years, Human Rights Watch various years). They are considered important ingredients of political openness and of people-centered public policy without which human development cannot take off or be sustained. Thus, states are increasingly pressed on their commitment to such issues as gender equality and equity, labor rights, elimination of the worst forms of child labor, and the rights to free speech and movement (see, among others, World Commission on the Social Dimension of Globalization 2004; UN 2005; UNICEF various years). Perhaps the most decisive call by the international community to make significant inroads into world poverty and other severe forms of human deprivation (such as preventable diseases and the looming challenge of water scarcity) is the Millennium Development Goals.[16]

But development advocates recognize that reversals of human development can easily occur, notably in times of economic downturn or crisis, when many

Box 2

SELECTED INDICES OF DEVELOPMENT AND SECURITY

The indices in the area of development and security are wide ranging. They assess country performance in meeting basic standards of human development and human rights; protection against such risks as unemployment, old age, and external shocks; and management of cross-border spillovers such as environmental pollution. Public policy promoting these concerns helps to advance globalization by providing a cushion for a country's residents.

The following selection of indices relating to development and security is drawn from approximately 70 such measures:

- Aging Vulnerability Index (Center for Strategic and International Studies and Watson Wyatt Worldwide)
- AIDS Program Effort Index (Joint United Nations Programme on HIV/AIDS, U.S. Agency for International Development, and POLICY Project)
- Assessing the Achievement of the Millennium Development Goals (United Nations Development Programme and World Bank)
- Bertelsmann Transformation Index (Bertelsmann Foundation)
- Climate Analysis Indicators Tool (World Resources Institute)
- Commitment to Development Index (Center for Global Development and Foreign Policy)
- Country Policy and Institutional Assessment (World Bank, International Development Association)
- Dashboard of Sustainability (International Institute for Sustainable Development)
- Democracy Score, Nations in Transit Ratings (Freedom House)
- Disaster Risk Index (United Nations Development Programme)
- Ecological Footprint and Living Planet Index (World Wildlife Fund)
- Education for All Development Index (United Nations Educational, Scientific and Cultural Organization)
- Environmental Performance Index and Environmental Sustainability Index (Columbia University and Yale University)
- Environmental Vulnerability Index (South Pacific Applied Geoscience Commission)
- Gender-related Development Index (United Nations Development Programme)
- Gender Empowerment Measure (United Nations Development Programme)
- Gender Gap (Population Action International)
- Global Natural Disasters Risks Hotspots (Columbia University)
- Global Terrorism Index (World Markets Research Centre)
- Governance Indicators (World Bank)

BOX 2 CONTINUED

SELECTED INDICES OF DEVELOPMENT AND SECURITY

- Human Development Index (United Nations Development Programme)
- Index of Social Vulnerability to Climate Change (Tyndall Centre for Climate Change Research)
- Mothers' Index and Early Motherhood Risk Ranking (Save the Children)
- National Biodiversity Index (United Nations Environment Programme)
- Overall Health System Achievement Index and Health System Performance Index (World Health Organization)
- Political Rights and Civil Liberties Ratings (Freedom House)
- Press Freedom Index (Freedom House)
- Reproductive Risk Index (Population Action International)
- Social Watch Scorecard (Social Watch)
- Sustainability Index (Zurich Cantonal Bank)
- Under Five Mortality Rank (United Nations Children's Fund)
- World Press Freedom Ranking (Reporters without Borders)

Source: Bandura 2005b.

poor people face a sudden income loss and, unable to fall back on their own savings, must rely on social protection. Thus, cluster 2 expectations also urge states to meet the triple challenge of satisfying increased demand for protection and insurance against the consequences of economic volatility, especially unemployment; satisfying the growing demand for old-age insurance, stemming from the aging of the population (as discussed by Heller in this volume); and observing established rules of monetary and fiscal prudence. States are encouraged to search for ways of complementing social security programs with increased (or even exclusive) private contributions and, in line with the cluster 1 expectations, to explore market-based insurance schemes. These topics have caught the attention of world leaders, among others, at summit meetings of the Group of Eight (G-8) and the World Economic Forum.[17]

In some instances individual insecurity is an outcome of personal circumstances or of the normal, competitive functioning of markets. In other instances, however, it is linked to a country's vulnerability—its exposure to external shocks such as international financial crises and their contagion effects, pollution spill-ins, spread of communicable diseases, natural catastrophes, or political violence, such as a terrorist attack. Therefore, the security component of cluster 2 urges states to do all they can to protect the country against external shocks, natural and human-caused. The report of the High-Level Panel of the United Nations Secretary-General on security challenges of the twenty-first century presents a comprehensive overview of the international policy recommendations on these aggregate threats to national security, which also bridge the span between security and development concerns (UN 2004).

Many external shocks result from negative cross-border spillovers from other countries. If all countries strive to reduce their negative cross-border spillovers, all countries will collectively experience fewer external shocks. Thus, the state is expected to increasingly observe certain limits to the global public "bads" that a country generates, particularly by reducing greenhouse gas emissions, controlling global communicable diseases, and fighting drug trafficking, international terrorism, money laundering, and web-based crime (UN 2004). In some areas new national allowances are being introduced to identify acceptable levels of border transgression, such as the carbon dioxide emission targets suggested under the Kyoto Protocol.[18] In other areas a list of expected reform measures may define what is in—or out of—bounds.[19]

Richer countries are encouraged to think not only about internalizing negative cross-border spillovers but also about generating positive ones, where this could contribute to solving global challenges. The Commitment to Development Index, for example, assesses donor country behavior from this dual perspective. It looks not only at the delivery of aid but also at how negative and positive spillovers from industrial country policies affect the development prospects of developing countries.[20]

The purpose of external policy expectations: a global framework for national policymaking

Taken together, external policy expectations seem to be calling on the state to foster globalization in two ways. States are to make globalization possible through national-level policy reforms along the lines suggested in cluster 1 and to make globalization politically feasible and sustainable by pursuing policy paths like those included in cluster 2 expectations. States are challenged to globalize particular national public goods as their contribution towards these two ends.

Cluster 1 expectations concern primarily the globalization of market-facilitating national public goods—goods that help markets emerge and function efficiently. The main suggested tools are open borders (so that national public policy domains can become interlocked), harmonized national policies and institutional and physical infrastructure (so that markets can integrate), and competitiveness (so that markets can expand and evolve).

Cluster 2 expectations focus on the globalization of market-embedding national public goods—goods that help people and countries cope with the normal volatility of markets as well as the tendency of some, especially financial markets, to generate boom and bust cycles. The main tools for this globalization are universalization (making select private goods, such as basic education, healthcare, and social protection, available for all or "public by policy design") and internalization of cross-border externalities (creating national public goods that prevent actions in one country from adversely affecting other jurisdictions).

A shared objective of the diverse external policy expectations seems to be to nudge individual nation states toward expanding their market failure–correcting role: from correcting the failure of domestic markets to also correcting the failures of integrating and progressively globalizing markets. Left to their own devices, individual states may underprovide essential market-facilitating and market-embedding public goods.[21] External policy demands may thus help tip national policy choices toward strengthening globalization and enhancing global welfare and development.

Do states meet these expectations?

National policy alignment: signs and driving forces

Under the Westphalian model, states would likely reject all external interference with their internal affairs or at least would be highly selective in their response. But actual policy practice worldwide looks quite different. Most national policy agendas contain clear echoes of external policy demands. And most countries—industrial, transition, or developing—seem to be undergoing far-reaching policy reforms to achieve further alignments. So what is driving the recent spread to so many countries of what Rodrik (1996, p. 11) has called the "reform bug"? The conditions of national policymaking sovereignty have undergone incremental but fundamental transformation leading to significantly changed political realities. Exclusive policymaking sovereignty entails increasingly high costs for states, while more responsive sovereignty is either the least-cost policy option or the policy path promising a real gain in national welfare.

Signs of policy alignment

Even a cursory examination of recent major surveys of global trends reveals that national public policy clearly echoes cluster 1 and 2 expectations.[22] Country case studies confirm this impression (box 3), as do many issue-specific analyses.[23] Public spending on global challenges such as HIV/AIDS control has increased. Policy approaches are converging, including lifting at-the-border controls, increasing decentralization, reducing red tape, imposing fiscal discipline and taming inflation, expanding public-private partnering, and substituting incentive policies for control and command measures. States the world over are promoting labor market flexibility and reforming social security and other public programs (Bandura 2005a). Anecdotal evidence is presented in box 4 to illustrate some of the country-level policy initiatives that seem to echo the cluster elements reviewed above.

Box 3

COUNTRY STUDIES ON INTERNATIONAL COOPERATION BEHIND NATIONAL BORDERS

As background for this chapter 19 case studies were conducted in developing and industrial countries (see list below). The studies examined international cooperation behind national borders, how countries adjust nationally to such global challenges as global warming, the policy norms used by sovereign credit rating agencies in assessing a country's creditworthiness, and newly emerging opportunities, such as new technology.

The studies reveal that global concerns are expressed in many different ways in national public finance policy. Sometimes budgetary allocations are adjusted to accommodate the provision of national-level inputs to various global public goods or aid concerns. Other times states change their delivery modalities, shifting, for example, from direct delivery of public programs to greater use of incentives, including guarantees and tax credits. Behind-the-border international cooperation is also reflected in national institutional reforms, such as new government structures for international terrorism control (especially in industrial countries) or management of the design and implementation of poverty reduction strategies. In brief, many of the concerns included in clusters 1 and 2 (see text) have found some traction at national levels.

The country case studies also indicate that while some industrial country interlocutors find the concept of international cooperation behind national borders slightly puzzling because they view international cooperation as an outgoing process, not an incoming demand, developing country interlocutors find the concept to be quite clear. This is especially evident in the least developed countries, where policymakers and government officials have to cope with a large number of donors—and their multiple requests.

Even where national policymakers and government officials intuitively understand the concept of international cooperation behind national borders, government machinery is not really set up to deal with global concerns. In most instances there is still a clear divide between "domestic" and "foreign" affairs. And although policies are adjusting to various external demands, it is often difficult to trace these changes in national budgets: new items are often conveniently "fitted" into existing budgets. There seems to be a growing awareness, however, that current government structures have to be revisited. In industrial countries reforms could usefully focus on developing the policy arm for incoming international cooperation demands. In developing countries the outgoing policy arm appears to need reinforcement.

BOX 3 CONTINUED

COUNTRY STUDIES ON INTERNATIONAL COOPERATION BEHIND NATIONAL BORDERS

Country studies and authors

Argentina, Humberto Petrei
Canada, François Vaillancourt
China, Ramgopal Agarwala
Egypt, Heba Handoussa, Nivine El Oraby, Mahmoud Mohieldin, and Doha Abdelhamid
Germany, Dirk Messner and Imme Scholz
India, Tarun Das
Japan, Toshihiro Ihori
Kenya, Francis M. Mwega
Republic of Korea, Joonook Choi
Netherlands, Harrie A. A. Verbon and Hanneke Wieland
Niger, Saidou Sidibe, Mahaman Sanoussi Tidjani Alou, and Joelle Bolho
Nigeria, Akpan H. Ekpo
Peru, Francisco Sagasti, Alvaro Espinoza, and Fernando Prada
Philippines, Cielito F. Habito
Russian Federation, Sergei Sinelnikov and Said Batkibekov
Sweden, Stefan Sjölander
Switzerland, Renate Schubert and Markus Ohndorf
United Kingdom, Alan Ingram, Graham Lister, and Malcolm Prowle
United States, Carol Lancaster

Note: These studies are available at www.thenewpublicfinance.org.

Drivers of policy alignment

How states respond to external policy demands depends in part on certain properties of the expectation: whether it is a more binding or a less binding norm, whether it is widely shared, and whether it comes with carrots or sticks attached. For example, Risse-Kappen (1995) argues that the more firmly entrenched and institutionalized an external policy demand is, the more difficult it is for a state to ignore it because demands for compliance become more difficult to suppress. Thus the passage of time may work in favor of more international cooperation. Yet that alone would not explain the growth in external policy expectations and the corresponding growth in national policy alignment, especially since the mid-1990s.

Four forces seem to propel these trends: waning political support for noninterference, increasing interdependence of states, growing political strength of transnational actors, and intensifying competitiveness between states.

Box 4

ECHOES OF EXTERNAL POLICY EXPECTATIONS IN NATIONAL PUBLIC POLICY

The following examples highlight a few national policy changes that appear to echo cluster 1 and 2 expectations.

Cluster 1: openness and competitiveness

- *Openness.* Trade and financial liberalization have progressed in the past decades and to that end states have even introduced changes in that most jealously guarded domain of national policymaking, the tax system. In many countries value-added taxes (VAT) have replaced trade taxes and other taxes on financial cross-border transactions (Cnossen 1998; Heady 2004; Keen and Simone 2004). As of 2001, more than 120 countries had adopted a VAT (Ebrill and others 2001, p. 8).
- *Competitive government.* States have also accepted competitiveness challenges. The indicators presented in the Overview of this volume show the increased porosity of the borders between the public and the private domains. Both privatization and public-private partnering are on the rise (Bangura 2000). Central bankers and finance ministers the world over strive to adhere to established rules of monetary and fiscal prudence, watching carefully how markets respond to their policy choices (Barlow and Radulescu 2002; Canova and Pappa 2005; de Ferranti and others 2000). Countries have also devolved fiscal, political, and administrative powers to lower levels of government. Some 95 percent of the world's 120 democracies have now elected subnational governments (Freedom House 2005; World Bank 2000, p. 107).
- *Fostering a conducive business environment.* Many developing countries are seeking to improve their business environment (Porter and others 2004a,b; World Bank 2004). Countries have sometimes created special economic zones that offer investors more advanced infrastructure and often more favorable investment conditions. As of 2002 there were some 3,000 export processing zones in 116 countries (World Bank 2004, p. 168). Moreover, regulatory restrictions have been removed, especially those that could impede foreign direct investment. Since 1995 some 60 countries have introduced regulatory changes considered favorable to foreign direct investment (World Bank 2004, pp. 111–12).
- *Innovation.* Innovation "hot spots" are emerging in developing countries, among them China, India, Israel, the Republic of Korea, the Russian Federation, Singapore, and Taiwan Province of China (Carey 2004). Industrial countries, feeling the pressure, are launching their own initiatives aimed at staying ahead in the technology and productivity game. For example, the Lisbon Strategy of the European Union is designed to make it the most dynamic and competitive

Box 4 Continued

Echoes of external policy expectations in national public policy

knowledge-based economy in the world by 2010 (European Commission 2004).

Cluster 2: development and security

- *Democracy and human rights.* The number of democratic states rose from 57 in 1985 to more than 120 in 2000 (Freedom House 2005, p. 5; UNDP 2002, p. 15). While there is still a long, unfinished agenda, recent decades have seen unprecedented advances in human rights. Nearly half the countries in the world had ratified all major international human rights instruments by 2000, up from 10 percent in 1990, laying the basis for national policy change (UNDP 2000, p. 3).
- *Poverty reduction.* More than 50 of the poorest countries have prepared Poverty Reduction Strategy Papers (PRSPs), reconfirming their commitment to poverty reduction (World Bank 2005b). In return, the international donor community has promised to increase official development assistance and has stepped up measures to promote policy coherence for development (OECD/DAC 2005).
- *Social security.* Social security reform is among the most hotly debated policy issues in many countries, industrial and developing alike (Blanchard 2004; de Ferranti and others 2000; Kapstein and Milanovic 2002; Södersten 2004). As of 2003 some 24 countries around the world had already incorporated private pillars to complement (or in some cases partially replace) their public pension schemes (Palacios 2003, p. 4). For many developing countries the main issue is introducing a system of protection and insurance or expanding a rudimentary one. For all countries a basic contested issue is the balance between a social, collective system and reliance on private responsibility, initiative, and choice, in line with cluster 1 expectations for enhanced competition between markets and states.
- *Economic risk management.* The search for a better public-private mix also marks national policy discussions on aggregate risk management. Many countries have built up sizable savings and stabilization funds to protect against external economic shocks (Fasano 2000; Davis and others 2001). Other countries are increasingly using futures and options markets to hedge against commodity price risks and exchange rate volatility (Institute for Financial Markets 2005; Morgan in this volume).
- *National security.* The terrorist attacks of September 11, 2001, raised new concerns about how to combine openness and national security. Many countries responded with increased public spending for international terrorism control (Bandura 2005a; Sandler in this

Box 4 Continued

Echoes of external policy expectations in national public policy

volume). By 2002 some 70 countries had raised or imposed new airport taxes (www.traveltax.msu.edu), and many proposed even higher levies. Alarmed by the number of catastrophic events in recent years, some states are encouraging markets for such new products as terrorism insurance or catastrophe bonds (Michel-Kerjan and Kunreuther 2004).

- *Management of cross-border externalities.* Countries have instituted national-level measures to curb transborder environmental pollution (Merlen 2005; Ocampo and Martin 2003; UNDP, UNEP, World Bank, and World Resources Institute 2003; World Watch Institute various years), along with market-based policy approaches (IETA 2003; Stavins 2003). For instance, in January 2005 the EU Greenhouse Gas Emission Trading Scheme commenced operations as the largest multicountry, multisector greenhouse gas emission trading scheme in the world. There is also evidence that spending on global communicable disease control has increased in many countries (UNAIDS 2003; U.S. GAO 2004).

As global surveys reveal only too clearly, wide diversity in policy outcomes and development remains between countries. But alongside such diversity is evidence of growing similarity, as countries increasingly adopt the same rules of the game.

Waning political support for noninterference. The norm of noninterference in the internal affairs of states had strong support among rival superpowers during the cold war era as a containment policy to keep states in the political bloc with which they were aligned. Many developing countries also strongly endorsed this norm, since it afforded them an opportunity to consolidate their recent status as independent countries, providing them with political breathing space and bargaining power. As the East-West conflict waned, so did support for the norm of noninterference. International policy conditionality became more overt, more elaborate, and universal in nature and was often accompanied by more intensive monitoring and heavier penalties for noncompliance.

Small, economically dependent countries in particular now feel that they have no choice but to comply with common external expectations or risk losing needed external assistance or other support (Addison and Roe 2004). They are the policy-takers in international relations, weighed down by multiple demands from donors, civil society, and markets. For states that are policymakers, the need to align is usually weaker because their government agencies, private business, and civil society have the capacity and resources to shape external exigencies. As a result, it is often their policy approaches, norms, and standards that are rolled out through the channels of international policy formulation and advocacy. Through foreign aid and other means they can help finance—and push—reforms in poorer developing countries. Between the policy-takers and the policymakers are states that have some choice of policy paths and reform speed.

Increasing interdependence of states—and more opportunities for cooperation. Global public bads such as financial crises, faltering world economic growth, SARS, and computer viruses tend to affect countries and people indiscriminately. Left unchecked, their costs accumulate. Thus, international cooperation is often cheaper and more efficient than lack of cooperation, and it allows states to effectively play their role of public goods provider. To the extent that external policy expectations reflect real global exigencies, even economically and militarily powerful states are adjusting their national policies. Think how swiftly countries around the world upgraded border security after the September 11, 2001, terrorist attacks on the United States.

But international cooperation is a response not only to increased interdependence. Sometimes the underlying motivation is to exploit new economic opportunities, such as access to international capital or insurance markets. But greater openness and more transborder economic activity increase a country's vulnerability to outside shocks, calling for greater international cooperation and setting in motion an incremental process of policy alignment and globalization.

Growing political strength of transnational actors. Nonstate actors have become influential policymakers, with power that states are forced to reckon with. Public policy reforms aimed at economic and political openness have set nonstate actors "free," enabling them to become more globally involved. The state, meanwhile, remains shackled to its territory. As a result, in many issue areas the state is no longer the actor with the overarching public concern. Nonstate actors are increasingly adopting a more global, public viewpoint to avoid missing out on opportunities in an open and interdependent world. Being territorially constrained compels the state to take the demands of nonstate actors into account, lest market actors vote with their feet and civil society raise its voice, "naming and shaming" the state into living up to widely accepted international norms and standards.

Portfolio investors, for example, can threaten to exit a country whose business climate is not up to international standards. One response by states has been to recast their taxation systems in areas sensitive to international differentials, such as corporate tax rates. The 2004 KPMG Corporate Tax Rate Survey covering 69 countries finds that the average corporate tax rate in Organisation for Economic Co-operation and Development countries fell from about 37 percent in 1997 to 30 percent in 2004 (KPMG 2004, p. 2). Corporate tax rates on especially profitable investments have fallen even more (Devereux, Griffith, and Klemm 2002). Slemrod (2004) finds an inverse relation between countries' openness and corporate tax rates.[24] Thus states' immobility is another important factor in their compliance with external policy expectations.

While business actors strengthen their public policy demands by threatening to exit or to adjust their risk assessments (and thus prices), the power of civil society organizations lies in networking across borders and raising their voices in concert. Sometimes they do so in loud and spectacular ways, as in 2001 at the G-8 summit in Genoa or in 1999 at the World Trade Organization (WTO) ministerial meeting in Seattle. Modern communication technology bestows worldwide visibility on such events and on their political leaders. More often, however, civil society organizations insert their views and demands more subtly yet persistently wherever global issues are debated and negotiated (Edwards and Zadek 2003; Scholte 2001; Scholte and Schnabel 2002). Consider the role of Jubilee 2000 in making states address the issue of developing country debt.[25]

Intensifying competitiveness between states. While increasingly influential, business and civil society do not often exert pressure on states directly. Rather, states compel each other to take external expectations into account, with "rival states" (Stopford and Strange 1992) competing for mobile factors of production by delivering what is expected of them, including fiscal restraint, quality standards, investment regimes, and even competition rules (Sinn 2003).

Competition is intensified by the impermanence of a state's place on the international competitiveness ladder, with some countries moving down as others move up (see the chapter by Shiller in this volume for an example). As developing countries such as China and India are meeting the global competitiveness challenge, industrial country firms and workers are experiencing added competition in markets they have long dominated.[26] Bhagwati (2004) even senses the beginnings of a reversal in sentiments about globalization. Industrial countries seem to be increasingly concerned about how well their firms will withstand stronger competitive pressures from developing country firms, while the more advanced developing countries appear increasingly confident that globalization can work to their advantage. A clear expression of industrial country concern is the debate on outsourcing, the migration of jobs from industrial to developing countries (Bhagwati, Panagariya, and Srinivasan 2004). Reforms in industrial countries to improve labor market flexibility and restructure social security are motivated in part by the desire to stay competitive.[27]

Thus states align their national policies to external policy demands because of strong compulsions and incentives to do so. Some align because this is the least-cost policy option for them, others align to enhance national welfare, and yet others align to cater to the special interests of powerful political constituencies, domestic or foreign (including perhaps, their own state interests).

For now, the required degree of alignment seems to be higher for developing countries than for industrial countries, and the net benefits of reform appear more elusive.[28] However, this may be gradually changing. As some of the more advanced developing countries climb up the competitiveness ladder, they seem to pull more of globalization's opportunities toward them. This places today's industrial countries under increasing competitive pressure. In Friedman's (2005) words, the world is increasingly "flat": a level playing field for industrial and developing countries. Alignment may well become more of a compulsion for industrial countries and more of an opportunity for developing nations.

Reflecting both the growing demand for national public policy alignment and growing economic strength, developing country policymakers are seeking a stronger voice in the international policy arena. For them, deeper integration requires more participatory, competitive international decisionmaking. Seeking to achieve further integration, they often find that the international rules of the game either do not fit their circumstances or are stacked against them. The Group of 20 (G-20) developing countries has been formed to give developing countries more clout in WTO negotiations.[29] Proposals have also been made to adjust quotas and decisionmaking in the Bretton Woods institutions to today's economic realities (Buira 2003). Another sign of the strengthened political role of developing countries is their leadership in financing cooperation to achieve the Millennium Development Goals, as through the establishment of a trust fund by the members of the India-Brazil-South Africa Dialogue Forum.[30]

Industrial countries, too, are supporting enhanced participation in decisionmaking as an important step toward strengthened policy ownership by developing countries. For example, it is now standard practice for a selected group of developing country leaders (its composition varying with the issues under consideration) to participate in G-8 summit events.[31]

Thus, states' responses to external policy demands appear to be driven by both compulsion and opportunity. As a result, today's states have two arms of policy intermediation:

- *An inward-directed policy arm,* which blends external and domestic preferences in formulating national policy to improve domestic economic activities.
- *An outward-directed policy arm,* which weaves national policy concerns into the formulation of external policy expectations, projecting the country's strengths to outside actors and exploring new global opportunities.

Replacing the Westphalian state with the intermediary state: implications for public finance

As Krasner (1995) shows, there have been compromises in the Westphalian state model from the beginning. Today, however, they appear to be the norm rather than the exception, a change rooted in new global realities. The time has come to reconceptualize the model of the state, to better reflect its actual role and to explore how such a reconceptualization might affect current mainstream public finance theory.

Key characteristics of the current role of the state

The three core elements of the state still apply, but as exclusive national policymaking sovereignty has evolved toward responsive policymaking sovereignty,[32] these core functions have been broadened:

- *From aggregating primarily national preferences to blending national and external policy demands.* A major role of states today is international cooperation behind national borders. By aligning national policies to external expectations, states achieve a matching of their policy framework with the global span of the goods that are typically at stake when policy alignment is expected of individual states.
- *From correcting market failure to also standing corrected by global business and civil society.* Business and civil society contribute in important measure to the pool of external policy expectations. In responding to the concerns of these actors, states in effect accept some correction of their policies by nonstate actors. Does this mean the capture of the state by particular private or civil society interests? Not necessarily, because nonstate actors—rather than states—often have the more global, public perspective. When they intervene in national public policymaking, it is often to promote global efficiency and equity.
- *From exerting coercive powers to being compelled to compete.* The state retains important coercive powers, notably in respect to less mobile domestic actors. However, when actors are mobile and network across borders, the state's coercive powers are blunted. To attract and retain mobile actors, states need to employ incentives that are at least as attractive as those offered by other states. States may align their policies and actively cooperate with external policy demands so as to compete more effectively with each other.

Thus, there is little evidence that the concept of the state as intermediary (box 5) means a hollowing out of the state (Ikenberry 2003; Kahler and Lake 2003; Sørensen 2001; Weiss 2003). States continue to play an important role. Yet how they play this role is significantly different from how they do so under the model of the Westphalian state.

Implications for public finance theory

Public finance and public economics textbooks give scant attention to issues of international cooperation. They tend to ignore issues of national-level policy alignment with external policy demands—issues of international cooperation behind national borders and issues of cooperation abroad. The concept of the intermediary state is important for its focus on the increasingly porous divide

Box 5

The intermediary state

In making national public policy, today's state takes into account external policy demands, constraints, and opportunities. All actors—states, business, civil society—contribute to the creation of the global pool of external policy expectations.

In exercising responsive national policymaking sovereignty, the state:

- Aggregates domestic policy preferences but also blends domestic and external policy demands.
- Corrects market failure but also stands corrected by global business and civil society, which intervene to correct public policy failure in the provision of national building blocks to global public goods or the management of cross-border spillovers.
- Exerts coercive powers, as in making and administering national law, but also recognizes that its coercive powers are blunted where nonstate actors can threaten exit or have a strong voice. While nonstate actors are increasingly mobile, states are bound to their territory—compelling them to compete with each other to attract mobile factors of production or to access global policy regimes, such as the multilateral trade regime or international financial markets.

In placing national public policy into the framework of external policy expectations, states engage in international cooperation behind national borders. As demand for such cooperation grows, so does demand by developing countries for more participatory cooperation beyond international borders. Thus, the intermediary state has two major policy arms: one for translating external expectations into national public policy and one for taking national concerns to the venues of international policy formulation so that the resulting expectations and norms fit a diverse range of national circumstances.

This actual role of the state differs in important ways from the model of the Westphalian state so often invoked in discussing the state's functions in public finance theory. In the Westphalian ideal type, the state exercises exclusive national policymaking sovereignty. The key characteristic of today's state in practice is responsive sovereignty—intermediation between domestic and external policy concerns.

between domestic and foreign policy matters, which calls into question the conventional division between domestically oriented public finance and international economics. Whereas public finance theory often assumes away the international economy, international economics focuses primarily on trade and finance issues, leaving aside many other public policy concerns that are increasingly global, such as health and the environment.[33]

New linkages between public finance theory and practice are one of the key themes of this book. This section simply alludes to some of the questions that the broadening of the three core elements of the state's role seems to raise. For example, how does the blending of domestic and external policy preferences affect what is considered an optimal provision of public goods? Textbooks suggest that a public good is optimally provided when the sum of the marginal willingness to pay of all the individuals who form a community (the citizenry of a country), for example, equals the marginal costs of providing an extra unit of the good. The intermediary state, however, may be expected to provide more or less of a good than is demanded domestically, by national taxpayers. It would be desirable for public finance theory to offer guidance to policymakers on how to assess and view such a situation.

Is it a case of the international community seeking to "buy" a global public service from a particular country or group of countries—say, biodiversity preservation—through an external policy demand? If so, the country facing the external policy demand might be justified in requesting some compensation for the incremental costs of providing the service (as discussed by King in this volume). Or is it a case of an external policy demand that seeks to encourage the state to internalize some negative cross-border spillover emanating from its jurisdiction, such as greenhouse gas emissions? If so, the state would be justified in expecting its citizens to bear the costs (especially if it were an industrial country with a record of high pollution).

Similarly, it might be useful to revisit the concepts of market failure and government failure. Nonstate actors sometimes intervene to pressure states into taking action to correct failures of globalizing markets. Are international markets failing under the same conditions as domestic markets? What should be the state's role in correcting international market failure? From an international perspective states are individual actors, and like other individual actors may be tempted to free-ride when it comes to providing global public goods or undertaking any other collective action needed to enhance the efficiency of global markets. International relations theory provides some answers. But still to be clarified is what predictions can be made about the role of nonstate actors in correcting both global market failure and related government failure.

Finally, an extensive literature deals with how states can use tax competition, tax incentives, and other persuasive measures to retain or attract transnational economic actors (see, for instance, Sinn 2003 and the chapter by Musgrave in this volume). Perhaps less well understood is the use and impact of incentive measures by mobile economic actors to encourage certain behavior by the state. For example, sovereign credit ratings can be seen as an incentive tool of market participants. Similarly, foreign aid donors move in and out of developing countries, responding, for example, to certain government behavior such as gross human rights violations. Such granting or withdrawing of aid could also be viewed as a tax measure.

While there are many more questions, those raised so far already demonstrate how substituting the model of the intermediary state for the model of the

Westphalian state would bring into focus a wide range of issues requiring research and policy debate to further illuminate the role of the state and public finance in today's world.

Conclusion

Comparing the actual role of the state and its role as depicted in public finance theory reveals three significant discrepancies: The state no longer merely aggregates national preferences but also seeks to blend domestic and external policy demands. The state still plays an important role in correcting market failure, but it also stands corrected by business and civil society actors who frequently intervene to correct public policy imperfections in the global (public) interest. The state still has coercive powers, but it also faces competitive pressures and has to compete with other states to attract mobile factors of production.

National policymaking sovereignty is no longer exclusive in the sense of shutting out external policy from business, civil society, or intergovernmental forums. Rather, it responds to these demands. As a result, the state resembles less and less the ideal-type Westphalian nation state that underpins much of public finance theory. A better reflection of reality is the concept of the state as intermediary. This discrepancy is apparent in public finance theory, which is based on this ideal type of the state rather than actual practice. Replacing the Westphalian state model with that of the intermediary state would thus require revisiting some of the basic concepts of mainstream public finance theory.

Notes

1. For many developing countries the period from the early 1970s to the 1990s was marked by two opposing trends. While gaining political independence from the former colonial powers, they were simultaneously confronted with demands to open up freshly drawn national borders. Transition economies encountered a similar situation at the end of the 1990s, when they emerged as newly independent states after the break-up of the Soviet Union. Thus, during the 1970s to 1990s, while the current era of globalization was gathering greater momentum, the Westphalian nation state was at its high point.

2. For the list of textbooks of public finance and economics reviewed for this chapter, see "Background Papers" at www.thenewpublicfinance.org.

3. Stiglitz (2000), for example, lists six conditions under which markets are likely to generate suboptimal outcomes: imperfect competition, public goods, externalities, incomplete markets, imperfect information, and unemployment and other macroeconomic disturbances.

4. However, none of these challenges makes state intervention automatically desirable. The state should intervene only if that is likely to enhance efficiency—not to compound market failure by government failure. Similarly, its equity or transfer

role should improve not worsen the primary income distribution resulting from the functioning of markets.

5. Origin rather than content is emphasized in defining the external character of a policy expectation because most actors involved in its formulation are "at home" somewhere. For example, nonstate actors are likely to advocate their concerns both domestically and internationally, so a substantive overlap between domestic and external policy preferences is likely. However, an important objective of nonstate actors in networking across borders and engaging internationally is to join forces in support of shared global concerns on which they would like nation states to act more decisively. Similarly, government negotiating teams represent a particular country. They may support an intergovernmental agreement to strengthen the political leverage of the state nationally. Tying the state's hands through an international commitment can help policymakers implement difficult reforms by referring to the country's obligation to other governments, intergovernmental organizations, or markets that do not permit alternative policy paths and the country's obligation to act as a responsible global citizen. Also, as Abbott and Snidal (1998) point out, states have to grant international organizations a certain degree of independence so that the organizations can function in the relatively neutral, even-handed manner essential to their legitimacy and authority in the eyes of their member states.

6. See http://untreaty.un.org/English/overview.asp.

7. Other examples include the Trade Policy Reviews of the World Trade Organization, reports countries prepare in compliance with their membership in the Financial Action Task Force and related regional entities, country reports on progress in implementing national-level measures to control international terrorism called for by United Nations Security Council Resolution 1373 (UN 2001), and reports on progress toward the Millennium Development Goals prepared by countries in collaboration with various United Nations agencies. For details, see Haller (2005).

8. This refers to a narrow definition of conditionality that includes quantitative performance criteria. For a discussion of problems in measuring conditionality, see Kapur (2001, pp. 212–17). For other studies on conditionality see Goldstein (2000) and IMF (2001).

9. See, for example, Standard & Poor's at www.standardandpoors.com, Moody's at www.moodys.com, and Fitch Ratings at www.fitchratings.com.

10. The indices are of interest here only for what they try to measure and not for what measurements they produce or how they rank countries. For details on each index, including information on its constituent components, refer again to Bandura (2005b).

11. As indicated by the arrows in figure 1, which link the components of clusters 1 and 2, the four sets of policy expectations are not mutually exclusive. In fact, there is much debate about whether a goal such as poverty reduction is better achieved through direct social spending by the state in such areas as basic education and health care, through the promotion of enhanced economic openness and competitiveness, or through simultaneous policy efforts in all these areas. Many policy analysts would argue that an integrated approach is the most promising.

12. For an overview of the issues in the Doha Round of multilateral trade negotiations, see Guha-Khasnobis (2004) and the WTO Doha Agenda web site: www.wto.org/english/tratop_e/dda_e/dda_e.htm.

13. According to the World Bank (2003, p. 124): "The practice of placing foreign and domestic sellers on an equal competitive footing is a hallmark of trade agreements. This objective is no less important in investment agreements. Promoting liberalization in international investment essentially boils down to securing nondiscriminatory terms of entry and operation."

14. Besides the dimensions captured by the relevant indices, see also such initiatives as the Revised International Capital Adequacy Framework, also known as Basel 2 (www.bis.org/publ/bcbsca.htm) and the work of the International Competition Network (www.internationalcompetitionnetwork.org).

15. For an elaboration of the theory of competitive government see, for example, Breton (1998), and for a discussion on how more competition within government could help meet current fiscal challenges see, among others, Dohrmann and Mendonca (2004). Decentralization has also been promoted for increasing competitiveness and for bringing the state closer to people; see, for example, the International Forum on Globalization (2002).

16. For the goals, see www.un.org/millenniumgoals. For reports on progress in achieving the goals in individual countries see www.undp.org/mdg/countryreports.html, for regional reports see www.undp.org/mdg/regionalreports.html, and for a worldwide overview see World Bank (2005a).

17. See, for example, WEF and Watson Wyatt Worldwide (2004), Federal Reserve Bank of Kansas City (2004), and G-8 (2003a).

18. See http://unfccc.int/resource/docs/convkp/kpeng.html.

19. The UN Security Council, for example, has adopted this approach for promoting follow-up to its Resolution 1373 against international terrorism.

20. For more detail on the Commitment to Development Index, see www.cgdev.org/rankingtherich/home.html.

21. It can be argued that not only are public goods one of the six cases of market failure listed by Stiglitz (2000) but that correcting the various conditions of market failure calls in most instances for the provision of a public good—such as enhanced information (to correct information asymmetries), a new property rights regime (to correct a problem of missing markets), or a reserve fund to provide protection against external shocks. Similarly, correcting various types of global or integrating market failure may require the provision of global(ized) public goods of a market-facilitating and market-embedding type.

22. For a comprehensive listing of these reports, see Haller (2005).

23. See, among others, Blanchard (2004); Bryant (2003); Drezner (2002); Hanson, Honohan, and Majnoni (2003); Held (2004); Kahler and Lake (2003); Keohane and Milner (1996); Mosley (2003); Rajan and Zingales (2003); Rodrik (1996); Schreurs and Economy (1997); Sinn (2003); Smith, Solinger, and Topik

(1999); Södersten (2004); Kapstein and Milanovic (2002); Underhill, Zhang, and Vines (2003); Weiss (2003); and Wijen, Zoeteman, and Pieters (2005).

24. So far, however, tax competition between states has occurred primarily within regions rather than across them (Ernst & Young and ZEW 2004; World Bank 2003). Because transnational corporations also compete with each other for "good" host countries (Chang 2003), states retain some room to maneuver.

25. There were Jubilee 2000 campaigns in more than 60 countries around the world. See, for instance, www.jubileeusa.org and www.jubilee2000uk.org.

26. For analyses of the potential of China and India to compete, see, for example, Basu (2004) and Virmani (2002a, b) on India, Shenkar (2005) on China, and Luce and McGregor (2005), Mallet and Merchant (2005), and Wolf (2005) for a comparative analysis of these two countries.

27. See, for example, the Hartz IV reforms in Germany at www.bundesregierung.de/en or the Social Security debate in the United States at www.whitehouse.gov/infocus/social-security.

28. In particular, the early structural adjustment programs in Sub-Saharan Africa often had high net costs for the countries concerned (Mkandawire and Soludo 1999; Cornia, Jolly, and Stewart 1987).

29. For details on the G-20 see www.g-20.mre.gov.br.

30. For details see www.dfa.gov.za/docs/2004/ibsa0305a.htm.

31. This practice began at the G-8 summit in Okinawa in 2000. For information on delegations at the most recent summits, see G-8 (2003b, 2004).

32. The notion of *responsive* sovereignty differs from that of *responsible* sovereignty as, for example, set forth by ICISS (2001). Responsive sovereignty is an objective concept. It neither judges the external expectations and norms (in terms of whether they are "good" or "bad" relative to certain higher order goals) nor implies that states must comply with them. Responsive sovereignty merely refers to the fact that states today take account of external expectations as well as constraints and opportunities when making national policy. Responsible sovereignty refers to states' responsibility to protect their communities from such atrocities as mass killing, systematic rape, and starvation. It is a normative concept.

33. Especially in the environment, new types of international trade in global public services have arisen, such as trade in carbon dioxide emissions (see the chapter by King in this volume).

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