Chapter 53
The Effects of International Openness on the Public Sector Growth:
An Evidence From OECD Countries

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ABSTRACT

Using Ordinary Least Squares (OLS) with panel corrected standard errors for OECD panel data this chapter, in contrast to Compensation hypothesis, finds a negative relationship between openness and the rate of public sector growth. In addition, this inverse relationship is found to be the strongest when electoral systems are more competitive. The empirical results presented here also suggests that openness constrains government growth more when the governments are run by either left-leaning parties or by left-leaning coalitions. This result holds for most measures of government spending and is robust to the inclusion of a wide range of controls. Unlike the existing empirical literature, which focuses on the 'compensation effect' of openness on government growth, this study supports the 'competition effect' of openness drawn from the literature on local public finance.

1. INTRODUCTION

Openness coming with globalization creates important changes on the structure of national economies as well as on many other things belong to the nations. One of the structural affect that it creates is related to size and scope of public sector in overall economy. While countries become more open in terms of increased volume of traded goods and services, and of increased mobility of capital, there has been a noticeable slow-down in the high rate of public sector growth in many of these countries in the most recent period. After all the criticisms about excessive rate of public sector growth in the earlier periods, this has been a positive development in government finance. Now, the question whether this seemingly inverse relationship between openness and government growth is a coincidence or real is still subject to an ongoing investigation.

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In the investigation on the nature of the relationship between openness and the growth of government budget, the existing literature stresses around two alternative hypotheses. Under the first one, which is called "compensation hypothesis," the government budget grows faster when economies become more open in order to compensate for potential income and job losses due to increased external risks and macroeconomic instabilities. Under the second one "competition hypothesis" however, the government budget grows slower because competition for mobile factors of production between governments of open economies lowers the cost of the public sector provision of goods and services and adversely affects the ability of independent governments to exploit their citizens.

The existing empirical literature that seems to be supporting both of the hypotheses about the relationship between openness and the rate of public sector growth is still unsettled and far from convincing. For instance, some studies find significant positive relationship while some others suggest no or negative relationship. The reasons for these controversies in the results are multifold. First, the results that are produced in these studies using varies methods of econometrics. Some techniques are just simple correlations or regressions with no consideration of time series or cross section related problems, while some others do not control for multiple sources of influence. Second, especially in political science literature, what happens to wasteful size of government budget or revenue-expenditure package is not viewed that importantly. They do not disentangle the effect of interactive factors such as economic and institutional variables.

Using recent econometric techniques and panel data, this article demonstrates that there is a negative relationship between openness and the rate of public sector growth. The relationship is robust to the inclusion of other critical explanatory variables such as country size, relative price ratio, and political competition and ideology. The evidence presented here supports the notion that integration of world markets for goods and services will be held accountable for allocating resources efficiently and for suppressing the rate of growth of the public sector.

The investigation in this article proceeds as follows: Section two offers some theoretical explanations for why and how does openness influence the allocation of resources between public and private sectors. Section three reviews the empirical literature and raises some concerns about the empirical validity of the existing studies. Section four presents the regression results that are obtained based upon the empirical model discussed in section two. Section five contains additional regressions in order to test the robustness of the results and provide alternative explanations for the inverse effect of trade openness on government growth.

2. LITERATURE REVIEW

Reported in the literature are two distinctly opposing effects of openness on national government size. At one extreme, openness is associated with a higher rate of government growth due to its exposure to external risk and macroeconomic instabilities. At the other extreme, openness is associated with a slower rate of government growth through its effect on fiscal competition. Both explanations seem appealing. According to the "compensation hypothesis", government spending grows faster because of risk-reducing demands by citizens' fear of greater external risk. According to the "competition hypothesis" however, inter-jurisdictional tax competition for mobile factors of production in open economies helps to tame the Leviathan or lowers the public sector provision.[1]

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