Chapter 3
How Does Globalization Affect the Government's Public Finance?
New Evidence From Developing Countries

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ABSTRACT

This chapter investigates the long-run effect of globalization on public finance using data of developing countries from 2005 to 2017. The present research makes a contribution to the literature from various aspects. Firstly, integration and cointegration properties of the variables are considered. Then, the cointegrating relationship between globalization and public finance indicators is estimated by employing the fully modified ordinary least squares (FMOLS) and dynamic ordinary least squares (DOLS) estimators. The empirical results are mixed. Globalization influences both government expenditure and public debt positively and significantly in the long run, while it influences tax revenue negatively. Moreover, the effect of globalization on the increased share of indirect taxes in the long run is more than the effect on the increased share of direct taxes.

INTRODUCTION

Globalization is an irrevocable process allowing for the free movement of goods and services, capital, people, and ideas among countries. Especially in developing countries, globalization has significant effects. On the one hand, the technology transfer from developed countries to developing countries positively affects economic growth and living standards with the productivity increase achieved in developing countries. On the other hand, the dependence of countries on each other leads to instability in the markets of developing countries, and economic and financial policies are formed under the influence of the globalization process.

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Globalization has become one of the most discussed subjects in recent years, and within this framework, discussions in the literature on the economic effects of globalization have been divided into two groups. While the effects on the primary income distribution, constituting the direct effects of globalization, are discussed in the first part of the literature, the impacts of globalization, constituting the indirect effects of globalization, on the activities of the government are addressed in the other part of the literature(Schulze and Ursprung, 1999, p. 296).

Within the framework of the indirect effects of globalization, there are three different views in the literature regarding the effects of globalization on public finance. According to the efficiency hypothesis, which is the first view, international competition increasing due to globalization will create a disciplinary effect on public finance and cause the government's size in the economy to decrease. According to the compensation hypothesis, which is the contradictory second view, the public sector will expand to reduce the external risk created by globalization. The final view regarding the effects of globalization on public finance argues that globalization does not have a considerable impact on the public sector's size.

Nevertheless, although the rate of the increase in public expenditures has slowed down since the late 1970s, GDP still constitutes a significant part of public expenditures in many countries. Especially since the 1970s, increases in public debt have resulted in a debt crisis in many countries, and debt crises have been experienced not only in developing economies, but high-income counties (e.g. Greece, Ireland after the 2008 financial crisis) have also faced the problems of not being able to repay the public debt (Cetin, 2019). During the same period, whereas the share of direct taxes in tax revenues decreased in many countries, an increase occurred in the share of indirect taxes.

In the literature, the effects of globalization on public finance have rather been addressed separately over taxes or public expenditures, and the effect of globalization on the budget (in a comprehensive way) has been one of the topics less focused in the literature. However, it is necessary to approach the effect of globalization on the budget as a whole, and in this scope, to evaluate how taxes, public expenditures and borrowing are influenced by globalization so that the effect of globalization on public finance can be discussed. On the other hand, the studies on the effects of globalization on public finance in the literature have rather focused on developed countries, and the effect of globalization on the budget in developing countries has been ignored. However, while the effects of globalization on developing countries are evaluated, it is important to investigate the effects created by globalization on the budget in the process of establishing financial policies supporting sustainable economic growth and development in the aforementioned countries. Accordingly, this study aimed to fill this gap in the literature.

In this framework, it is aimed to explore the long-run effect of globalization on public finance for developing countries by using data from 2005 to 2017 in this paper. For this purpose, firstly, integration and cointegration features of the variables are considered. Then, the cointegrating relationship between globalization and public finance indicators is estimated by employing the Fully Modified OLS (FMOLS) and Dynamic Ordinary Least Square (DOLS) estimators. Employing two various estimation methods provides us with the opportunity to investigate the sensitivity of the results to the estimation method. In this respect, the organization of this paper's outline is presented below. In the subsequent part, the literature on globalization and its effects on public finance is discussed in a brief manner. Part 3 presents the data and methodology. The empirical findings are given in part 4. The conclusion is presented in part 5.

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