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Do more open economies have bigger governments? Another look

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Abstract

We reconsider the evidence of a positive relationship between openness and the size of government recently established by Rodrik [Rodrik, D., 1998. Why do more open economies have bigger governments? Journal of Political Economy 106, 997–1032] and others. While the existing literature focuses on expenditure based measures of government, we consider non-budgetary measures such as government ownership of enterprises, price controls, asset expropriation. Each of these may have little impact on government expenditures, yet can make the role of government sizable. We demonstrate that the scope of government is much larger in less open economies when considering non-budgetary measures. Additionally, we show that higher levels of non-budgetary government are positively correlated with trade barriers. Finally, we provide further evidence on the hypothesis that larger governments provide social insurance in open economies subject to terms of trade shocks. Although we find that greater terms of trade risk is weakly associated with larger government in all forms, these interventions include price controls and greater risk of asset expropriation which are hard to reconcile with a pure insurance motive.

JEL classification: O19; H19; H59
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1. Introduction

The relationship between the size of government and openness to trade has been examined extensively in the recent literature. Conventional wisdom suggests that smaller governments will be associated with more openness since both indicate less intervention in the economy. In addition, open economies may have smaller governments as intervention is either less effective in more open economies or interventionist policies reduce competitiveness on global markets. However, government size could increase in response to greater openness. Larger governments may occur in more open economies to compensate those groups which lose from trade.[1]

Empirically, the existence of a strong, positive correlation between openness and the size of government among the OECD countries has been established in the literature for some time.[2] More recently, a series of papers by Rodrik (1997a,b, 1998) demonstrates that this correlation exists for a broad sample including both developed and developing countries. These papers have generated renewed interest in the literature as authors have sought explanations for the correlation.[3] In the present paper, we pursue a different route and investigate whether or not the correlation between openness and the size of government is robust to the *measure* of government.

Although there are a variety of ways in which the size of government is measured in the literature, they are almost exclusively expenditure based. However, the influence of government in an economy goes beyond its spending and tax collections. State ownership of enterprises, price controls, mandates, and restrictions on competition are examples of government intervention that can have profound effects on an economy yet have little impact on the government budget. Thus, government may be "large" with a relatively small expenditure.[4] In fact, our prior expectations are that non-budgetary aspects of government are very important in understanding the link between government size and openness because, in a broad sample of countries, differences in institutions and the relative size of the budgetary and non-budgetary components of government are likely to be significant.

In the current paper, we examine the relationship between openness and both budgetary and non-budgetary measures of the size of government. Our results indicate that focus on strictly budgetary measures of government misses much of the picture regarding the relationship between the scope of government and openness. We demonstrate that, in many respects, the scope of government is much larger is less open economies. In addition, we show that much of the association between the various forms of government and openness is explained by per capita GDP. Lower income economies tend to have more non-budgetary intervention and more closed economies while high income countries are more open and have greater government expenditure. As a corollary, we demonstrate that higher levels of non-budgetary government, in all forms, are positively correlated with

[1] Garrett (2001) classifies these competing explanations as the "efficiency" or "compensation" hypotheses.
[2] Cameron (1978) provides an early analysis of this relationship.
[3] Notably, Rodrik (1998), Alesina and Wacziarg (1998), Garrett (2001), and Iversen (2001).
[4] Hillman (2003, p. 604) makes a clear statement of the importance of non-budgetary aspects of government. Also, see Peacock and Scott (2000) and Saunders and Klau (1985).