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Foreign investment, international trade and the size and structure of public expenditures

Norman Gemmell [a,*], Richard Kneller [a], Ismael Sanz [b]

[a] *School of Economics, University of Nottingham, University Park, Nottingham, NG7 2RD, UK*
[b] *Faculty of Economics, Universidad Complutense de Madrid, Campus de Somosaguas, 28223 Madrid, Spain*

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Abstract

The ‘compensation’ and ‘efficiency’ hypotheses propose that globalization affects both the total, and composition of, public expenditures in different ways. Under the former, economic insecurity leads to expanding public sectors and social expenditures, whereas under the efficiency hypothesis, demands for lower taxes encourage smaller public sectors, and especially ‘privately productive’ spending. We test these hypotheses for a sample of OECD countries from 1980–1997. Using both the inward stock of FDI and openness as measures of globalization we find no effect on the size of government, but FDI significantly shifts the expenditure composition towards social spending, favouring the compensation hypothesis.
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1. Introduction

The increased integration of the world economy over the last few decades has led to growing interest in its effects on different aspects of national economies. One aspect that has drawn particular attention is the effect on government spending and taxation decisions. The literature describes these effects under two competing hypothesis. The ‘efficiency hypothesis’ highlights the effects of globalization on the supply side of the political market: competition between countries to attract FDI leads to a reduction in taxation, particularly capital taxes, and the size of the public sector, and a restructuring in the composition of government expenditure towards privately productive public inputs. The ‘compensation hypothesis’ in contrast, highlights the effects of globalization on the demand side of the political market: voters pressurise governments to provide more social insurance to mitigate the exposure to greater levels of external risk induced by globalization, thereby increasing social welfare expenditures.

* Corresponding author.
E-mail address: norman.gemmell@nottingham.ac.uk (N. Gemmell).

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Empirical evidence on whether the efficiency or compensation hypothesis dominates is inconclusive (Schulze and Ursprung, 1999). Evidence in favour of the compensation hypothesis is broadly balanced by a similar number of studies supporting the efficiency hypothesis. In part it is likely that the differences in empirical outcomes between studies reflect inconsistencies in the choice of empirical methodology and the sample of countries, as well as the choice of fiscal variables and the indicators of globalization. In this paper we take a number of steps to mitigate the effect of these choices on the results, to test robustness to alternatives, and to understand where sensitivities in the existing literature might be generated. In so doing we make some extensions to the methodology and data used to test the effects of globalization on government expenditure.

The empirical methodology we adopt proceeds in two stages. First, we examine the effects of globalization on the size of government before later considering the effect on the composition of those expenditures. For the size of government regressions we compare the results using three methods found in the current literature: OLS, two-way fixed effects and dynamic panel models. Our primary innovation comes from the methodology used to study the effects on expenditure composition. Here we employ a system of dynamic panel regressions with each fiscal category expressed relative to total government expenditure (rather than say, GDP). This approach requires comprehensive coverage of expenditure data and, more importantly, recognition that the expenditure categories are interdependent through the government budget constraint. By expressing the fiscal categories relative to total expenditure we maximise the opportunity for finding significant compositional effects from globalization. This assumption is supported by the results from regressions explaining government size where no robust evidence of an effect from globalization is found.

We also depart from existing studies with respect to the choice of measure of globalization used. Within the existing literature globalization has typically been captured by measures of openness to international trade, episodes of capital liberalisation, or FDI flows. Dreher (2006) however constructs a more comprehensive index of globalization which includes separate elements capturing 'economic integration', 'political integration' and 'social globalization'.[1] This paper is concerned with the economic aspects of globalization and uses two measures that contribute to the economic integration component of Dreher's index. In particular, motivated by the evidence linking the presence of foreign multinationals with perceptions of economic insecurity (see Schmidt, 1999; Scheve and Slaughter, 2006) we use as our baseline measure the stock of inward FDI. Those authors have argued that in the US and UK greater FDI has been associated with increased job insecurity. However, given previous arguments, and evidence, that trade openness may affect public spending decisions (see, for example, Rodrik, 1998; Garret, 2001) we also examine the impact of trade openness on the size and composition of government spending.

To the extent that these arguments regarding FDI apply more widely and impact on public expenditure choices, it might be expected that it is the stock rather than the flow of FDI that best captures this. Where inward flows of FDI are relatively large, for example, but existing stocks are low, this may have a limited impact on perceptions of insecurity. Conversely in a national economy where the capital stock is predominantly foreign-owned, but current foreign investment is low, insecurity may nevertheless be high. However, we test the robustness of our findings based on inward FDI stocks to a number of alternative trade, investment and globalization measures, as well as considering whether the results are unique to foreign capital. Finally, to reduce the potential sensitivity to differences in the degree of fiscal decentralization and therefore the sample of countries, we also depart from much of the existing literature and use data on government spending at the consolidated general level.

Using data for 25 OECD countries over the period 1980–1997 we find evidence in favour of a modified version of the compensation hypothesis. Firstly, we do not find robust evidence to support the compensation hypothesis claim of an effect of openness or FDI on total government expenditure.[2] This result is insensitive to the measure of globalization adopted — the stock of inward FDI or openness to international trade. However, the econometric method used appears to be important. Our results show that allowing for country/time fixed effects and/or dynamics within panel regressions renders both these aspects of economic integration irrelevant in regressions seeking to explain government size.

Secondly, tests on the composition of government expenditure yield clearer outcomes. Here we find unambiguous support for the compensation hypothesis. Larger stocks of inward FDI have a positive effect on social welfare spending

[1] 'Political integration' is measured in Dreher's index by membership of international organisations, participation in UN missions etc.; 'social globalization' includes data on international contacts (telephone traffic) and tourism. Economic integration includes international trade and investment flows and data on 'restrictions' such as import barriers.

[2] Within the existing literature only Dreher (2006) has reached a similar conclusion.

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