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Does Globalization Restrict Budgetary Autonomy?

Does globalization restrict the leeway for national budgetary policy? With the help of cluster and discriminant analysis this study provides evidence on the basis of the experience of OECD countries since the 1970s. The results suggest that while globalization does indeed matter for government budgets, substantial room is left for individual national policies particularly with regard to public expenditure structure and public debt.

The compatibility of national sovereignty and increasing global integration is at the heart of the globalization debate. In the fiscal field the question is to what extent the increasing mobility of production factors constrains budgetary policy. In Europe the introduction of the Euro has intensified this debate since a further increase in the mobility of real and financial capital is expected. An increasing number of politicians regard liberalization as a danger for the attainment of domestic policy goals, e.g. in the social security field. In reaction to that some advocate tax coordination or even restrictions on international capital mobility.

While the theoretical analysis of the impact of globalization on government budgets is already advanced, empirical analysis has not yet reached a comparable stage. The existing empirical studies have two striking shortcomings. First, there is an analytical imbalance insofar as many studies are predominantly concerned with the development of government revenues. The impact of factor mobility on the complete government budget, i.e. revenues as well as expenditures and public deficits, is rarely taken account of in a comprehensive way. Second, there are only few studies that try to measure the impact of globalization on public finance explicitly. The following approach is frequently applied: trends in the structure of revenues in recent decades are identified and significant changes are then ascribed to globalization. Thus the implicit assumption of this traditional approach is that the time-scale is sufficient to measure the stage of globalization reached by a country. This assumption is highly questionable. For different industrial countries at a given point in time the extent of globalization has often been very different, e.g. because of the existence of restrictions to international transactions.

Due to this identification problem some conclusions found in the literature appear premature since changes in the fiscal structure might be motivated by reasons very different from factor mobility. The decreasing share of corporate taxation in the government revenues of some countries may serve as an example. This empirical fact seems to be in line with the prediction that with the increasing mobility of some factors the burden of taxation is shifted from the mobile to the immobile tax basis. However, an alternative explanation exists: the reduction of taxes on enterprises has been recommended by supply-side economists in order to improve the environment for investments and employment. Therefore, the tax shift away from corporate taxation might - independently of tax competition and purely on domestic grounds - be motivated by the desire to create a growth-stimulating tax system.

Against this background the approach of this study is the following. The impact of globalization on government budgets is analyzed in a multidimensional way: the consequences of the OECD countries'}
growing international integration are studied for different dimensions of public finance – for the size of the budget, the tax structure, the expenditure structure and the public debt. Theory suggests that these dimensions could be affected. The time perspective is long-run as changes in fiscal variables from the 1970s to the 1990s are analyzed. Furthermore this approach follows the relatively few studies that use explicit measures of globalization. International integration as a possible driving force for changes in government finance is measured in the form of variables for the existence of capital and current account restrictions, for the size of international trade and the exchange rate regime. Thus, an attempt is made to avoid the shortcomings of many existing empirical studies and to take account of national differences in globalization exposure.

The empirical tools employed are cluster and discriminant analysis. In a first step, cluster analysis helps to identify fiscal country clusters, i.e. subgroups of the total country sample with similar fiscal developments in recent decades. In a second step, the usefulness of globalization variables is tested with regard to their power to discriminate between these clusters.

The results suggest that globalization has indeed had an impact on government budgets, although this impact is limited and does not concern all budgetary dimensions. The growing international integration of a country has been associated with a relatively low growth of government although this growth remained substantial in absolute terms even for very globalized countries. The findings support the view that growing market integration restricts the tax burden on corporate income. Substantial leeway remains, however, on the expenditure side. Furthermore, the findings do not indicate any effective globalization restrictions on public debt.

The Hypotheses

Globalization might have an impact on four dimensions of the government budget: the revenue structure, the expenditure structure, the level of deficits and the level of the budget. Among these four dimensions the revenue structure impact – under the heading of “tax competition” – is the one most intensively analyzed in the theoretical public finance literature. If capital is mobile and labor immobile and if the expenditure side of the government budget does not have the character of a production input, globalization will compete capital taxes down and lead to an underprovision of public goods. With increasing globalization the share of capital taxation would thus be expected to decrease and the share of taxes on immobile factors to increase.

If, however, the expenditure side of the budget has the character of a production input, the consequences of globalization on tax structure are less clear and lead to a debate on the validity of models in the tradition of Tiebout. In this model local governments providing local public goods compete for mobile taxpayers, resulting in an efficient allocation. The resulting locational competition is regarded by some authors as a helpful disciplining mechanism to foster efficiency. Among others, rejects Tiebout due to his too restrictive assumptions. However, the theoretical debate on tax competition and its extension to the expenditure side of the budget leads to the identification of testable hypotheses with regard to two government budget dimensions:

- **Tax structure hypothesis**: Globalization forces governments to adjust the tax structure. Taxes have to be shifted away from mobile factors towards immobile ones.
- **Expenditure structure hypothesis**: Globalization forces governments to adjust expenditure structure. Expenditure shares must be changed in order to benefit the needs of mobile taxpaying factors at the cost of reducing benefits for immobile taxpayers.

Adjusting the expenditure structure for the benefit of mobile taxpayers has the character of a substitute for the adjustment of the revenue structure. Only empirical analysis can find out which strategy is actually applied by fiscal actors faced with the increasing mobility of some tax bases.

Globalization might be a relevant process not only for taxes and expenditures but also for public debt. This interrelationship has been touched on in the debate on EMU and public debt. Lane ascribes a disciplining function to open capital markets in this context. If public debt exceeds the level that is sustainable, capital flight and increasing risk premia are the consequence. The disciplining function of open capital markets could, however, be neutralized if

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1. See Günther G. Schluze, Heinrich W. Ursprung, op. cit., for a non-technical summary of the main results.