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The impact of globalization on the composition of government expenditures: Evidence from panel data

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Abstract According to the disciplining hypothesis, globalization restrains governments by inducing increased budgetary pressure. As a consequence, governments may attempt to curtail the welfare state, which is often seen as a drag on international competitiveness, by reducing especially their expenditures on transfers and subsidies. This globalization-induced welfare state retrenchment is potentially mitigated by citizens' preferences to be compensated for the risks of globalization ("compensation hypothesis"). Employing two different datasets and various measures of globalization, we analyze whether globalization has indeed influenced the composition of government expenditures. For a sample of 60 countries, we examine the development of four broad expenditure categories for the period 1971–2001: capital expenditures, expenditures for goods and services, interest payments, and subsidies and other current transfers. A second dataset provides a much more detailed classification: public expenditures, expenditures for defence, order, economic affairs, environment, housing, health, recreation, education, and social expenditures. However, this second data set is only available since 1990—and only for OECD countries. Our results show that globalization did not influence the composition of government expenditures in a notable way.

Keywords Globalization · Economic policy · Government expenditure composition · Tax competition

JEL Classification H7 · H87 · C23

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1 Introduction

The number of scholarly investigations of the nexus between globalization and the welfare state is impressive and the literature is still growing at a rapid pace. The scientific community contributing to this literature is by no means restricted to the economics profession; political scientists, in particular, but also sociologists and other social scientists have been strongly involved in this ongoing academic endeavour. Even though there can be no doubt that one of the driving forces behind this research activity is intellectual curiosity regarding the essential consequences of one of the arguably most important economic phenomena of our time, it appears that many social scientists are also attracted to the subject because of the public debate that the globalization issue has aroused. Since globalization has far reaching effects on so many important aspects of everyday life, it is a topic well suited for political entrepreneurs to rig the public political discourse and to mobilize political support. The political agents who have used the globalization issue as a vehicle to advance their agendas range from well-meaning public figures concerned about the globalization induced social dynamic, to political demagogues and street rioters.

The worries of the well-meaning objectors to global economic integration originate in the conviction that globalization will bring about a loss of power of the nation states in general, and a reduction in welfare state activities, in particular. The reasoning behind these fears runs as follows: trade liberalization and liberalization of factor mobility, via indirect factor price equalization and direct arbitrage effects, erode the developed countries' income and capital tax bases and will eventually give rise to a global tax race to the bottom which, in turn, results in the nation states' fading ability to finance welfare state activities. This downward pressure on the supply side of public welfare programs, depending on the viewpoint of the observer, reduces the efficiency of *benevolent governments* (cf. Sinn 2003) and/or disciplines *egoistic governments* who transform discretionary power into benefits for their clientele (cf. Breton and Ursprung 2002). The so-called "efficiency" or "discipline" effect of globalization thus reduces the range and size of government welfare programs.

By focusing on the efficiency effect of globalization, the opponents of global economic integration and unchecked systems competition neglect, however, the demand side of the political market. The demand-side effects of globalization derive from the governments' political support maximization motives that direct the political process towards a redistribution of the globalization induced economic gains, i.e., losers from globalization are to some extent compensated via an increase of social welfare programs. The so-called "compensation" effect of globalization thus undermines the "efficiency" effect, implying that from a theoretical point of view the total effect of globalization on the extent of national welfare programs remains ambiguous.

Given the theoretical ambiguity of the nexus between globalization and national welfare policies, it is not surprising that much of the respective literature is empirical. However, as the literature review in the next section shows, a robust impact of globalization on government expenditures does not appear to exist. The reason might be that compensation and disciplining effects neutralize each other. It is possible, however, that the impact of these two effects depends on the type of expenditure. Therefore, any true test investigating the impact of globalization on expenditures has to focus upon shifts in the relevant expenditure shares. It is this link between globalization and expenditure shares that our paper deals with. We follow the strategy of using disaggregated data and superior econometric techniques that characterize the second-generation studies on the globalization-welfare state nexus. In contrast to the existing literature we do, however, not estimate the impact of globalization on *individual* policy dimensions, but acknowledge that all policy measures are to some extent