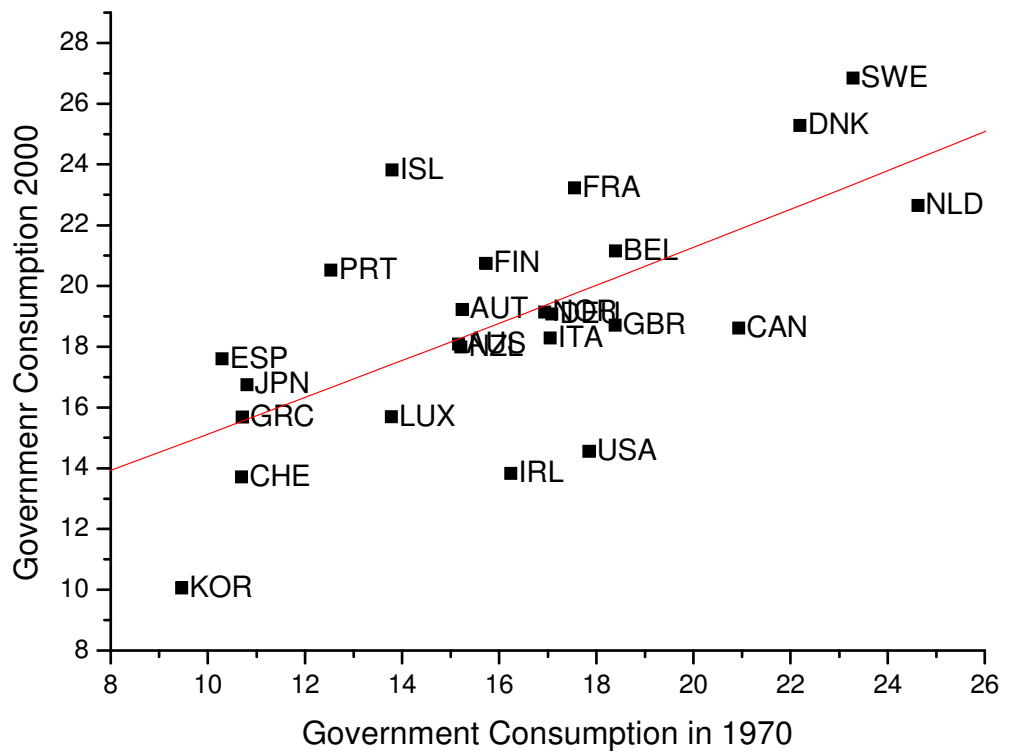
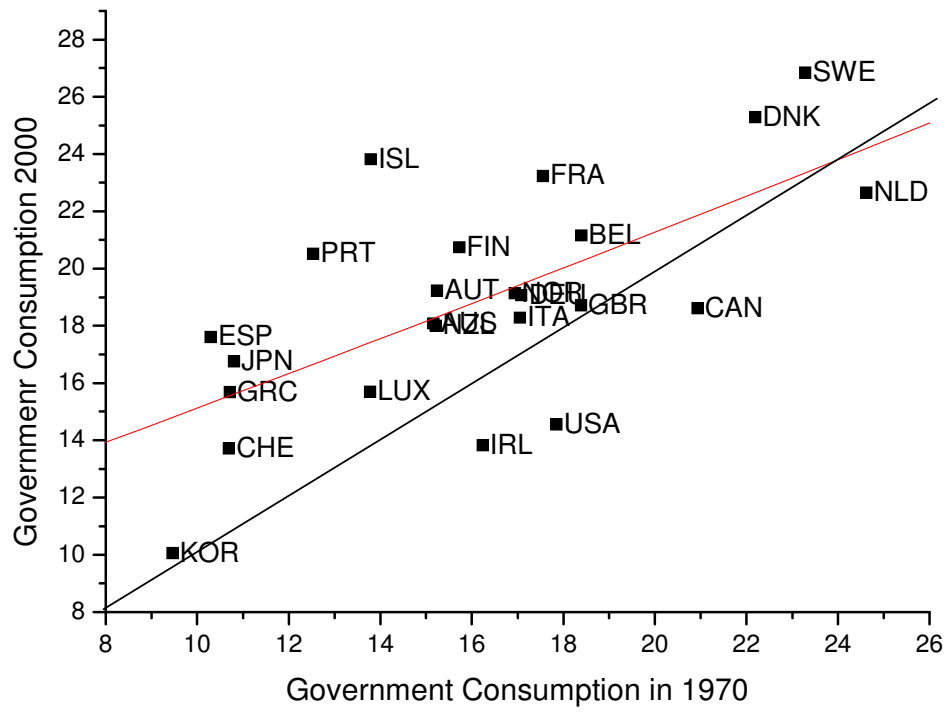
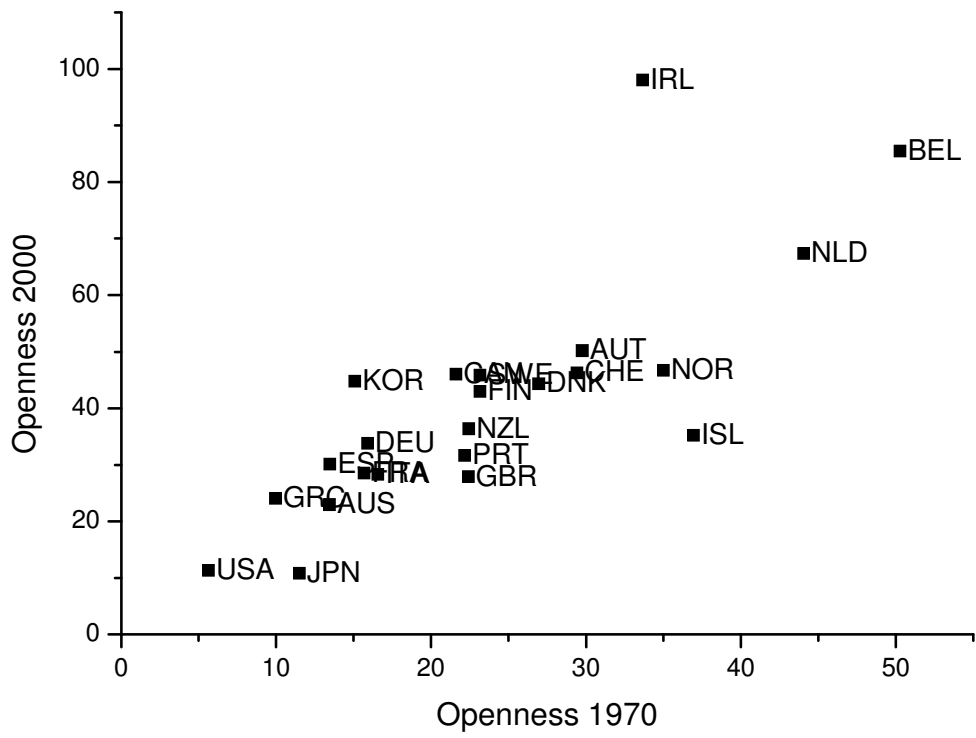


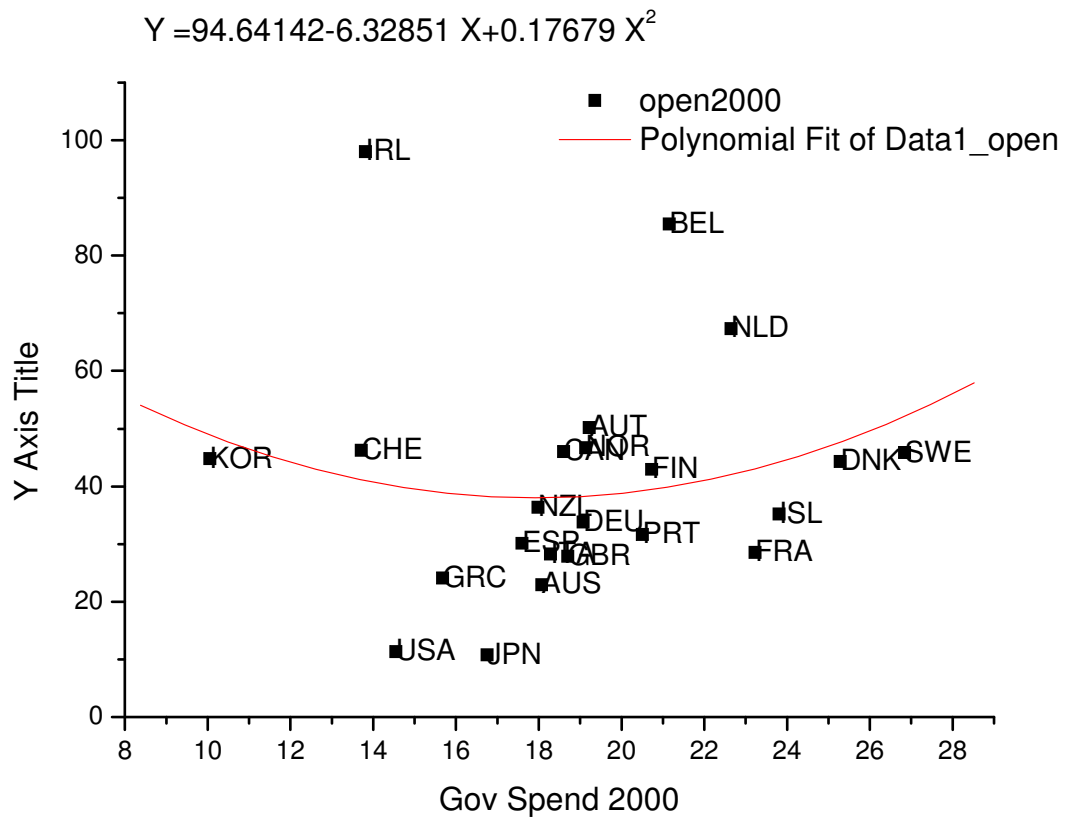
Trade, International Economic Openness, Capital Flows and Government Spending 1

1. Two Theories, two predictions
2. Some empirical evidence









Compensation hypothesis

The more open to the global economy countries are, the more they spend on social transfers.

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Variant 1:

Governments are (at least partly) opportunistic.

Trade (economic openness) creates more winners than losers.

The losers must be compensated.

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Doubts:

Trade increases economic growth, increases the number and reduces the price of available goods, and is thus more likely to produce more winners.

Opportunistic governments do not need to compensate a small minority of losers. And the median-voter is extremely unlikely to suffer from 'globalization'.

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Variant 2 (Rodrik 1997):

Economic openness increases the volatility of the economy (by adding global volatility to national volatility).

Economic volatility increases the risk of becoming unemployed for all employees outside the public sector. This is likely to include the median-voter.

Voters will thus demand a better social insurance scheme.

Hence: higher spending of social transfers.

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Doubts:

More open economies are actually LESS volatile, simply because bigger markets are less volatile than smaller markets. Hence, economic openness does not increase economic volatility but actually reduces it.

Iversen (1997): “ A priori, one would expect high exports to be associated with lower volatility (...). The reason is that participation in international trade makes it possible to escape excessive dependence of small home markets.”

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Variant 3 (Cameron 1978):

Trade openness causes specialization, which leads to a higher degree of organization among workers. Hence, unions and left parties are strong in open countries. These political actors seek to push government spending and especially social transfers upwards.

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Doubts:

Link between specialization and degree of union's organization weak (at best).

Left parties are nowadays much less in favor of increasing government spending than in the 1970s.

Efficiency hypothesis

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Doubts:

Link between low growth and government behavior is unclear. Do voters really compare the economic growth rate of their own country to the growth rate of other countries when casting their vote?

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Variant 2:

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Doubts:

Governments do not need to finance social transfers by corporate taxes or labor taxes.

Corporations are by far less mobile than the hypothesis suggests.

Other arguments for compensation or efficiency hypothesis?

Empirical evidence:

Replication of Garrett and Mitchell (2001)

	Model 1.1	Model 1.2
	Garrett/Mitchell model	results reported by Garrett and Mitchell
Government Spending _{t-1}	0.914 (0.019) ***	0.911
Unemployment	0.0214 (0.0388)	0.033
GDP per Capita Growth	-0.365 (0.0319) ***	-0.362
Dependency Ratio	0.0837 (0.0453) *	0.097
Left Cabinet Portfolios	-0.0023 (0.0020)	-0.003
Christian Democrat Portf.	-0.0042 (0.0037)	-0.005
Trade Openness	-0.0258 (0.0110) **	-0.030
Low Wage Imports	0.0266 (0.0165)	0.023
Foreign Direct Investment	-0.0072 (0.0565)	0.006
N	529	529
R ²	0.999	0.999
Wald χ^2	33652.78	
prob> χ^2	0.000	
PCSE	Yes	yes
time dummies	Yes	yes
country dummies	Yes	yes

Alternative Explanations: Left and Right Parties over Time

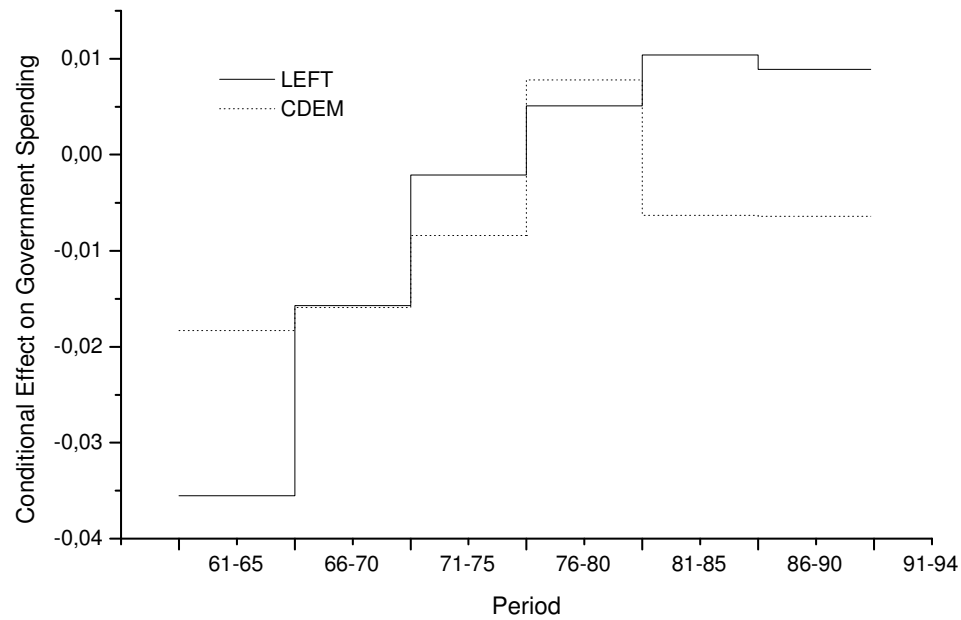


Figure 2: The Conditional Effects of LEFT and CDEM in Government Spending