GLOBALIZATION, DEMOCRATIZATION AND GOVERNMENT SPENDING IN MIDDLE INCOME COUNTRIES

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1. INTRODUCTION

Research on the relationship between integration into international markets and the welfare state has a long and distinguished history. There are three major findings in the literature. First, countries that are more exposed to trade tend to have larger public economies, allowing governments to compensate those who are adversely affected by international competition (and maintaining political support for openness (Ruggie 1982)). The original result was for the OECD (Cameron 1978), but more recently Rodrik (1998) has shown that the positive trade-spending nexus holds for the developing world as well. Second, it has recently been argued that this relationship is stronger in more democratic regimes where the political incentives are greater for governments to mitigate market-generated inequalities of income and risk (Adsera and Boix 2001). Finally, many analysts suspect that increasing capital mobility in recent years has put downward pressure on the public economy (see, for example, Rodrik 1997), but exploratory empirical work has not confirmed this conjecture (Garrett 2001a, Garrett and Mitchell 2001, Quinn 1997, Swank 1998).

In this paper, we explore the globalization-government spending relationship in middle-income countries, which we consider to be particularly interesting from the standpoint of broader debates about national autonomy in the global economy.[1] The dynamics in middle-income countries are likely to be different from those in the OECD for at least two reasons. First, integration into international markets has tended to increase more rapidly in middle-income countries in recent decades. Second, transitions to democracy in the past two decades have given political power to would be globalization losers in political systems that may not be sufficiently stable to withstand the conflict this

might generate. On the other hand, political economic dynamics are also likely to be different from those in low-income countries with largely autocratic regimes, where government spending is often used as a way to feather the nests of public officials and their cronies rather than redistributing wealth and risk broadly throughout society.

Our analysis yields three central findings. First, irrespective of how one measures the level of exposure of national economies to international markets (that is, not only trade, but also flows of foreign direct investment and policy restrictions on the capital account), more integrated middle-income countries tend to have larger public economies. The relationship found is much stronger for FDI and restrictions on capital movements, but the results are consistent with the Cameron-Rodrik thesis and holds quite broadly across the middle-income countries.

Second, government spending has risen less quickly in middle-income countries in which the increase in capital mobility has been most dramatic between the 1980s and the 1990s. This is consistent with popular perceptions about the constraining effects of financial integration.

Finally, in countries in which political regimes became more democratic over these two decades, heightened international market integration of all sorts was associated with faster growth in government spending. Thus, there has been a virtuous circle in middle-income countries among globalization, democratization and bigger government. Integration into international markets has promoted economic development in middle-income countries (Garrett 2001b), this development has made successful transitions to democracy possible (Przeworski et. al. 2000), and newly democratic governments have

used the public economy to redistribute the fruits of openness broadly throughout society.[2]

The remainder of the paper is divided into four major sections. Section 2 briefly reprises the contending theoretical arguments about the effects of globalization on the public economy. Section 3 describes over-time and cross-national variations in market integration and government spending in middle-income countries. Section 4 presents our regression analysis. We summarize our results and discuss their implications by way of conclusion in Section 5.

2. EFFICIENCY, COMPENSATION AND GLOBALIZATION

There are two basic positions in the globalization and government spending debate. The conventional wisdom about globalization constraints on the public economy can be called the "efficiency" hypothesis because it highlights competitiveness pressures and threats of exit by mobile asset holders. The "compensation" hypothesis, in contrast, emphasizes the domestic dislocations generated by globalization and the incentives for government interventions in the economy that these generate.[3]

The Efficiency Hypothesis

The fundamental tenet of the efficiency hypothesis is that government spending – beyond minimal market friendly measures such as defense, securing property rights and other fundamental public goods – reduces the competitiveness of national producers in international goods and services markets. There is no market for, and hence no market constraints on, publicly provided services. Income transfer programs and social services distort labor markets and bias inter-temporal investment decisions. Moreover,

government spending must be funded, often by borrowing in the short term, and ultimately by higher taxes. Taxes on income and wealth directly erode the bottom lines of asset holders and distort their investment decisions, and this is exacerbated the more progressive tax systems are. Borrowing results in higher real interest rates, which further depresses investment. If this also leads to an appreciation in the real exchange rate, the competitiveness of national producers is decreased.

According to the efficiency hypothesis, therefore, there is a zero-sum quality to the relationship between trade and the size of government. It does not matter whether one considers trade liberalization as the inevitable product of exogenous technological innovations in transportation and communication or as the conscious choice of governments to reap the benefits of trade (scale economies, comparative advantage, and the like).[4] Either way, exposure to trade should curtail government spending.

This logic is thought to be even more powerful with respect to capital mobility, particularly financial capital. Traders operating 24 hours a day can instantly move massive amounts of money around the globe in ceaseless efforts increase returns on their investments. For many, the potential for massive capital flight has rendered international financial markets the ultimate arbiters of government policy. The logic underpinning this view is straightforward. Governments are held to ransom by mobile capital, the price is high, and punishment for non-compliance is swift. If the policies and institutions of which the financial markets approve are not found in a country, money will hemorrhage unless and until they are. In turn, financial capital is usually thought to disapprove of all government policies that distort markets, and excessive government spending is among the most prominent villains.

In sum, the efficiency hypothesis contends that government spending should have been subjected to powerful lowest common denominator pressures as a result of the increasingly global scale of markets in recent decades. From the Depression until the 1970s, it may have been possible for governments to expand the public economy at little cost, because this was a period of relative closure in the international economy. In the contemporary era of global markets, however, the trade off between efficiency and welfare is harsh and direct, and governments have no choice but to shrink the state.

The Compensation Hypothesis

The efficiency perspective's focus on the economic costs of government spending overlooks the possibility that there are political incentives to expand the public economy in response to globalization and that these may outweigh the constraints imposed by market integration. Globalization may well benefit all segments of society in the long run through the more efficient allocation of production and investment. But the short-term political effects of globalization are likely to be very different. Expanding the scope of markets can be expected to have two effects that would heighten citizen support for government spending – increasing inequality and increasing economic insecurity.

The effect of trade is likely to be more pronounced on inequality than insecurity in the OECD, with the converse more likely to obtain for much of the developing world. In accordance with Hecksher-Ohlin models, expanding trade will reduce demand (and hence employment opportunities and incomes) for relatively scarce factors of production (labor in the "north", capital in the "south") while increasing demand for abundant factors. This should result in increasing inequality in the OECD, but more equality (as labor benefits from market integration) in developing countries (Wood 1994). In

contrast, trade patterns are not particularly volatile in the OECD and are characterized by very high levels of intra-industry and intra-firm trade. As a result, trade growth is unlikely to increase economic insecurity much in the advanced industrial democracies. But given more specialized patterns of trade in the developing world, volatility – and hence economic insecurity – should be more widespread in these countries (Rodrik 1997).

There is less work on the domestic effects of capital mobility. One reasonable premise, however, is that rising capital mobility should increase substantially both inequality and insecurity in the OECD, and that these effects should be even more apparent in less developed countries. The primary beneficiaries of financial market integration are the owners of liquid assets and those in the finance sector – or more specifically, large financial houses in the wealthiest OECD countries. It is less clear that these benefits trickle down to other segments of society, or across national borders. Moreover, unexpected and massive volatility comes hand in hand with financial globalization – as the headline crises of the 1990s attest. The societal insecurities associated with this volatility are likely to be large, and more pronounced in countries with greater short term international liabilities (i.e. the LDCs).

Democracy

Adsera and Boix (2001) argue that the compensation hypothesis is more likely to hold in more democratic political regimes, whereas the efficiency dynamic is more likely to dominate policy choice in more autocratic regimes. The reasoning behind this argument is straightforward. Democratic leaders have a greater incentive to address the political demands of broad swathes of society, and in particular those of rank and file

workers whose electoral support is likely to be essential to their continuing political success. Making sure that capital performs its "public function" of investing is just as important, perhaps more important, for democrats than for autocrats, but there are good reasons for capital to support a somewhat redistribute democratic government. This is Ruggie's (1982) compromise of "embedded liberalism", in which democratic redsitribution of income and risk is a small price to pay for broad public support for openness.

This logic is likely to be even stronger in democratizing regimes. Pent up citizen demands for redistributive government are likely to be high, and newly established democratic governments are likely to be particularly sensitive to meeting these demands. In turn, economic actors know that public sentiment for supporting market losers could well be channeled into protectionism, and building up a large public economy is a way to avoid this outcome.

It should be noted that we are not directly concerned with inequality of income or wealth. Even closed economies may decide to redistribute wealth from the rich to the poor (or vice versa) and such redistributive pressures will always be present. Rather, what concerns us is redistribution from groups that are benefiting from globalization to groups who are suffering. Quite often the groups declining will not be the poorest of the poor since they were operating in what was once a profitable niche in the economy. In fact, in order to express a meaningful political voice and receive compensation, a group must have some resources a government cares about (e.g., money or people). Inequality is certainly important and plays a role in how compensation is provided, but it is not our immediate concern in this analysis.

Let us now move on to the empirical evidence concerning the relationships among globalization, democratization and the public economy in middle-income countries.

3. OVER-TIME TRENDS AND CROSS-NATIONAL VARIATIONS

Government Spending

The two broadest available measures of the size of the public sector are total central government spending and consumption expenditures for general government. Total central government spending comprises all types of central government activity, but it does not capture expenditures by state and local governments. Most middle-income countries are quite centralized, but there are important exceptions – notably Argentina and Brazil (in which more than 40% of public spending occurs at the state and local level (Garrett and Rodden 2001)). The consumption-spending variable, in contrast, takes into account all levels of government. But this only measures the purchase of goods and services by government. One can argue that much of this spending redistributes wealth and risk. Public health and education are obvious examples, but all forms of public employment likely benefit disproportionately the less well off and the lower skilled.

It must be noted, however, that the general government consumption measure does not take into account some facets of government that are central to conventional conceptions of the welfare state – most notably income transfer programs such as pensions and sickness and unemployment benefits. Income transfer payments are typically much smaller portion of government spending in middle-income countries than in the OECD, but again there are some important exceptions – particularly in transition

countries. Latvia, Belarus, and Bulgaria all devote roughly 12% of GDP to social security and welfare transfer programs.

In essence we are using size of government, as measured by total central government expenditures and general government consumption, as a rough proxy for compensation to groups that lose out from globalization. Since each measure captures a slightly different facet of welfare effort, we report results using both measures. It could be argued, of course, that we should measure compensation more narrowly – say using unemployment benefits and pensions or education and health spending. We use the broader size of government measures for two reasons. First, the data for disaggregated expenditures is not as widely available. Our goal was to analyze government responses to globalization for as wide a range of middle-income countries as possible and not only those that are covered by the IMF's *Government Finance Statistics*.

Second and more important, governments can and do compensate sectors of the economy in ways that are not easily captured in a single class of expenditures. For example, Esping-Andersen (1990) considers the corporatist/Christian democratic welfare states of the Benelux countries and the social democratic welfare states of Scandinavia equally redistributive. But the Christian democratic model relies on income transfer programs that are most run by central governments, whereas the Scandinavian systems are characterized by the generous provision of public services (education, health and daycare) that are often decentralized. Neither is inherently "better" in terms of compensation, and it would seem imprudent to use a narrow definition of welfare effort that might exclude important redistributive programs.

Figure 1 plots over time trends in our two broad measures of the public sector, based on (un-weighted) averages of spending relative to GDP for all middle-income countries for which the data are available. Although the scale of general government consumption is considerably lower than that for total central government spending (a ratio of almost 1:2) and although general government consumption has been more volatile, the overall trends in the two variables are quite similar. Government spending in middle-income countries increased quite rapidly in the 1970s, stabilized or somewhat declined in the 1980s, and then rose again appreciably in the 1990s. On both variables, for example, government spending in 1998 was a larger fraction of GDP than at any other time in the preceding three decades. The overall growth in spending for the 1973-1998 period was about 50% (from 20% to 30% of GDP) with respect to total central government spending; the growth in general government consumption was more modest, from about 13.5 to 16% of GDP (roughly 20%). Finally, one should remember that average GDP per capita in the middle-income countries increased by more than 50% in real terms from the early 70s to the late 1990s. Thus, the rate of growth in real government spending was much higher than it would seem from these plots normalized to GDP.

Figure 1

These averages for all middle-income countries, however, conceal important variations among different types of countries in this grouping. Figure 2 plots averages with respect to general government consumption for four groups of middle-income countries – the transition economies of the former Eastern bloc, Latin America, oil exporters, and other middle-income countries. General government consumption more

than doubled as a portion of GDP among oil exporters from 1973 to 1990 – a graphic example of Wagner's law that society's demands for government spending increase with higher levels of per capita income. With the onset of the Gulf war, however, this tend was reversed. Nonetheless, average general government consumption was still higher at the end of the 1990s among oil exporters than any other type of middle-income countries.

General government consumption also appears to have increased by more than 50% during the 1980s in the transition economies, but then was flat in the 1990s – even though the massive economic dislocations in this period should have greatly increased demands for government compensation. But one should be suspicious about official statistics from the communist period. Finally, government consumption in Latin America and the remaining middle-income countries, in contrast, was quite stable over the whole sample period. And in the 1990s, the Latin American countries spent less on government consumption than any of the other groupings.

Figure 2 about here

Figure 3 plots over time variations in central government spending by country type. The trends in these data are different from those for general government consumption in several ways. First, government spending during the Gulf War dominates the oil exporters line. Second, total government spending roughly halved in Latin American countries in the middle of the 1980s – in response to the debt crisis – but then increased by about one third in the 1990s (not returning, however to the portions of GDP in the 1970s). Third, total government spending declined quite steadily in the transition economies from the late 1970s to the late 1990s, with the largest drop occurring immediately after the end of communism.

Figure 3 about here

Let us now turn to differences in public spending across middle-income countries in the 1990s (Table 1). The most important thing to note here is that there are large variations in patterns of government spending within each of our country groupings. Consider first the transition economies. Government spending in the 1990s was far higher, for example, in Croatia, the Czech Republic and Poland than in Albania and Russia.[5] Turning to Latin America, Argentina and Mexico both have very small public economies, whereas Brazil's (and Costa Rica's) is much larger. Government spending in Chile, the darling of market reformers, fell somewhere in between these two extremes. In the remaining middle-income countries, government spending is highest in Botswana (the one country in Sub-Saharan Africa that seems to have escaped the development trap) and Oman and lowest in some of the East and Southeast Asian NICs – notably South Korea, the Philippines and Thailand.

Table 1 about here

What explains these over-time and cross-national variations in government spending? We begin by presenting data on market integration and political regimes then move on to analyzing their relationships with government spending.

Market Integration

We use three different measures of integration into international markets. Total trade (the sum of exports and imports as a % of GDP) is the simplest and most widely analyzed aspect of market integration. Figure 4 presents un-weighted average trade dependence among different groups of middle-income countries. The most important feature of this graph is perhaps the fact that trade dependence increased markedly after

1985-1986 in all types of countries – on average by about 20 points of GDP. This is wholly consistent the view that the period from the mid 1980s on constitutes the new era of globalization. As was the case for government spending, developments in oil exporters and the transition economies were more extreme than those in Latin America and other middle-income countries, but nonetheless the directions of change are quite consistent.

Figure 4 about here

Figure 5 plots total inflows plus outflows of foreign direct investment as a percentage of GDP for these types of countries (note that inflows overwhelm outflows in most middle-income countries). The general story in these data is quite similar to that for trade – FDI took off from mid-late 1980s on. To be sure, this was more pronounced in transition economies and among oil exporters, but annual FDI flows increased in Latin America from about 0.5% of GDP in the early 1980s to 2.5% of GDP in the latter 1990s.

Figure 5 about here

Finally, Figure 6 plots over time changes in capital mobility, using a new 0-9 scale of capital account restrictions derived from IMF data (Brune, Garrett, Guisinger and Sorens 2001). As was the case for both other measures of openness, it is clear that the period from the mid 1980s on was one of rapidly increasing integration into the international economy for middle-income countries. Unlike trade and FDI, however, the trend to capital account openness was most pronounced in the Latin American countries. On average, capital account were more closed in these countries in the 1980s than they had been in the 1970s – almost as closed, in fact, as the transition economies were in the years before the fall of the Soviet Empire. By the mid 1990s, however, the Latin

American countries were considerably more open than the other three groups of countries, which had converged to very similar policy positions on the capital account.

Figure 6 about here

Table 2 focuses on differences across countries in terms of international economic integration in the 1990s. The table makes clear that there is enormous heterogeneity in the extent of market integration within country groupings and among different facets of market integration. One clear association is that smaller middle-income countries tend to have more integrated economies (compare, for example, Georgia and Russia among former parts of the Soviet Union, or Brazil and Jamaica in the Latin American group) – presumably because smaller nations are more dependent on external markets to realize scale economies.

But it is also apparent that openness on one dimension does not necessarily translate into openness on other dimensions. For example, the two largest countries in Latin America, Argentina and Brazil, remain among the world's smallest traders (relative to their GDPs). But Argentina had among the most open capital accounts for all middle income countries in the 1990s, whereas capital mobility in Brazil was much more limited. Few countries are open on every measure like Jamaica or closed by every measure like Iran. There are a few striking cases where countries are very open by one measure and very close under another. For instance, Panama has few capital controls and attracts significant FDI, but relies little on trade. Malaysia and Gabon have economies dependent upon FDI and trade, but restrict capital movements. Belarus and Bulgaria have closed capital markets and do not attract much FDI, but have economies highly involved in trade.

Table 2 about here

Combining Tables 1 and 2 one could attempt to provide a rough preliminary assessment of the efficiency and compensation hypotheses in middle-income countries. Big spending governments in open economies like Croatia, Czech Republic, Costa Rica, Botswana, and Oman point towards the compensation hypothesis. The same can be said for closed economies whose governments spend little on welfare in countries such as Russia, Albania, and Korea. However, there are countries such as Poland and Brazil that have large public economies despite being relatively closed – as predicted by the efficiency hypothesis. Similarly, countries like Thailand that have relatively small public expenditures in an open economy also support the efficiency hypothesis. It would be easy to choose a set of case studies to support whatever hypothesis one wants.

An alternative strategy would be to look at over time trends in government spending and market integration. Grossly speaking, one might be willing to claim on the basis of Figure 1 that government spending increased in the 1990s, following closely on the move to more economic integration in the latter 1980s. This would seem to support the compensation view. But one could equally look more closely at the time trends in government spending and market integration – broken down by country type – and find evidence for the efficiency view. For example, spending was relatively flat in Latin America in the latter 1980s and 1990s, even though market integration increased considerably over this period. One might then discount development among the transition economies and the oil exporters and *sui generis*, and not particularly related to globalization.

Our take on such efforts to discern tight relationships from the descriptive data is that they are fruitless. We want to take country level differences in spending and integration seriously, as well as over time times in these variables among countries. We should also take into account the fact that political economic dynamics in transition economies, for example, may have been very different than those in Latin America. It is for these reasons, that we use multivariate regression analysis in the next section to allow us more precisely to delineate the relationships of primary interest. Before we do that, however, we wish briefly to discuss trends and cross national differences in political regimes that may well significantly mediate in the relationships between international market integration and government spending.

Political Regimes

Figure 7 plots over time changes in political regimes, using the common –10 (complete autocracy) to +10 (complete democracy) measure derived from the Polity III database. It is true that the middle-income countries as a whole democratized considerably during the 1973-1998 period, but this broad development conceals at least two important sub-trends. On the one hand, Latin America was always more democratic than other middle-income countries, and it democratized as a continent fairly steadily from the early 1970s to the late 1990s. On the other hand, the clearest regime shift in the data is the dramatic transition from communism to democracy in the countries of the former Soviet Bloc. In the late 1990s, these countries were on average just as democratic as those in Latin America, and considerably more democratic than other middle-income countries.

Figure 7 about here

Table 3 presents national level data on political regimes in the 1990s. The lessons of these data are familiar. Most ex-communist countries became quite democratic in the 1990s, with some notable exceptions such as Uzbekistan and Yugoslavia. By the 1990s, most of Latin America was also quite democratic, again with some notable exceptions (Cuba, and to a lesser extent Mexico and Peru). Oil exporters continued to have quite authoritarian regimes in the 1990s. The remaining middle-income countries were a mixed bag, ranging from wholly democratic (Mauritius and Papua New Guinea) to very authoritarian (Libya, Oman and Syria).

Table 3 about here

4. REGRESSION ANALYSIS

In order to isolate the associations between market integration and government spending, we estimated several types of OLS regressions (with heteroskedasticity-consistent standard errors) for all middle-income countries with populations over one million. The basic form of the simplest equation was:

$$SPEND90s = \alpha + \beta_1 MI80s + \beta_j CONTROLs + \beta_k DUMMIES + error \qquad (1)$$

In this equation, the spending variables (general government consumption and total central government spending) were measured as average percentages of GDP in the 1990s (typically, 1990-1998). The three market integration terms (trade and FDI flows as a percentage of GDP, and the 0-9 index of capital account openness) are all averages for the 1980s. This specification mitigates the problems of reverse causality that might otherwise plague this analysis. That is, countries with larger public economies might subsequently choose to open their economies; we are more interested in the responses of

governments to the extent of market integration (i.e. viewed as a largely exogenous condition).

We included three control variables that are standard in the literature. Countries with larger populations are expected to have smaller governments (as a result of scale economies in the provision of public services). Higher dependency ratios of those under 15 and over 64 to people of working age should be associated with higher levels of government spending. Finally, following Wagner's law, countries with higher GDP per capita are expected to have larger public economies.

Our regressions also included three dummy variables that take into account the possibility that different types of middle-income countries might have different levels of government spending. We used a dummy variable for the Latin American countries because this is the largest group of countries in our sample. One might expect that the transition countries of east and central Europe might have larger public economies than other middle-income countries in virtue of their communist histories. Finally, we also added a dummy variable for oil exporting nations.

This baseline specification allows us to ask the following question: was government spending in the 1990s higher or lower in countries that were more integrated into international markets with respect to trade, FDI and capital mobility in the 1980s?

However, given that we know that the extent of market integration increased substantially between the 1980s and the 1990s, it is also worth asking a follow-up question: did government spending increase between the 1980s and 1990s faster or slower in countries in which market integration increased more rapidly between these decades? The functional form of the estimated equation was thus:

$$\Delta SPEND = \alpha + \beta_1 \Delta MI + \beta_2 \Delta GDPPC + \beta_k DUMMIES + error \qquad (2)$$

In this equation, the spending and market integration variables are all expressed as changes in natural logs (i.e. ln(90s) – ln(80s)). This allows us to talk about the elasticity of spending with respect to market integration ("a one percent change in integration is associated with an x percent change in spending"). We continued to include the dummy variables for different types of middle-income countries. Dependency ratios and population only changed marginally in most countries between the 1980s and 1990s, so we excluded them from the regressions to preserve degrees of freedom.

Finally, we assessed the mediating effects of political regimes by asking the following question: how did the extent to which a country democratized between the 1980s and 1990s affect the relationship between changes in market integration and changes in spending? This equation can thus be written as:

$$\Delta SPEND = \alpha + \beta_1 \Delta MI + \beta_2 \Delta DEM + \beta_3 \Delta MI * \Delta DEM$$

$$+ \beta_4 \Delta GDPPC + \beta_k DUMMIES + error \qquad (3)$$

In this equation, one can assess the combined effects of changes in political regime and changes in market integration on changes in spending by estimating spending changes on the basis of β_{1-3}, multiplied by different values of market integration and democracy.

Levels of Market Integration and Levels of Government Spending

Table 4 reports our baseline results concerning the impact of levels of market integration in the 1980s on levels of government spending in the 1990s. In the general government consumption equation on the full sample of middle income countries with populations over one million (column 1), higher dependency ratios and higher GDP per

capita in the 1980s were both strongly and positively associated with more spending in the 1980s. But government consumption was about 4 points of GDP lower in Latin America than in other middle-income countries. Latin American countries also had much lower central government spending in the 1990s, whereas spending was much higher in transition economies and a little higher among oil exporters (column 2).

Table 4 about here

For the full sample of middle-income countries (columns 1 and 2), trade had a weakly positive and statistically insignificant impact on both general government consumption and total central government spending. Given the collinearity between FDI, capital mobility, and trade we do not view this as repudiation of the broader Cameron-Rodrik thesis. There was a somewhat stronger positive capital mobility effect, though in neither equation did the estimated parameter quite reach traditional levels of statistical significance. It is clear, however, that countries with greater average flows of foreign direct investment in the 1980s had higher levels of government spending in the 1990s. These effects were statistically significant and substantively large with respect to both general government consumption and total central government spending. A one standard deviation increase in average annual FDI flows (1.32% of GDP), for example, is estimated to have increased both central government spending and government consumption by 1.32*1.60 = 2.1 points of GDP. Average government consumption in the 1990s in these countries was 15.6% of GDP in the 1990s; the mean for total central government spending was 27.2% of GDP. Thus, the positive effects of FDI on the public economy were quite large.

We then ran the same type of regressions for the Latin American countries to ascertain whether the positive effects of market integration evident in the whole sample were also apparent for this group of countries. The broad answer is that they were, though in this case, the significant positive relationships between integration and spending were for trade and capital mobility rather than for foreign direct investment. In the general government consumption equation (column 3), a one standard deviation (for the Latin American countries only) increase in trade is estimated to have increased spending by 29.2*0.12 = 3.5 points of GDP; a one standard deviation increase in the capital mobility index would have increased spending by 2.36*0.58 = 1.4 points of GDP. Since average general government consumption in the Latin American countries in the 1990s was 12.1% of GDP, these were substantively large effects. For total central government spending, a one standard deviation increase in capital mobility among Latin American countries is estimated to have increased spending by 2.36*1.20 = 2.8% of GDP, compared with a mean for total government spending in 1990s Latin America of 20.9% of GDP.

In sum, Table 4 lends strong support to the compensation view. Countries that were more exposed to international market forces had larger public economies. This is wholly consistent with Cameron's original work on the OECD and Rodrik's more recent findings for a global sample of countries. While Cameron and Rodrik use trade as their measure of openness and we find no relationship between trade and government spending, the broader argument that more open economies have larger governments holds. It is possible that different types of economic openness receive different governmental responses, but it is also possible that trade is swamped by collinearity with

the other two variables. It is important to note that the positive effects of FDI and capital mobility on government spending have not been found in studies outside the middle income countries (Quinn (1997) is a partial exception).

Changes in Market Integration and Changes in Government Spending

These levels results, however, are subject to a potentially telling criticism. Globalization connotes for most people the notion that international market integration has increased dramatically in recent years – and our descriptive statistics confirmed that this has indeed been the case in middle-income countries. It is interesting that countries that were more integrated into international markets in the 1990s tended to have larger public sectors in the 1990s, but perhaps those in which market integration has been faster have experienced slower growth in the public economy? Garrett (2001) and Garrett and Mitchell (2001) found evidence that this was the case both for the OECD and for a broader global sample of countries.

Table 5 presents our estimates of the effects of globalization – now measured as changes (in logs) in market integration between the 1980s and the 1990s – on changes (in logs) in government spending between the two decades. The basic structure of the estimated equations is similar to that for Table 4, except that we excluded the relatively stable population and dependency ratio variables to preserve degrees of freedom. As would be expected, economies that grew more quickly between the 1980s and the 1990s experienced slower spending growth (as a percentage of GDP) because of the stickiness in spending programs. Spending growth was also considerably slower in the transition economies and among oil exporters than in other middle-income countries.

Table 5 about here

In the general government consumption equation for all middle-income countries, faster growth in trade and FDI were weakly associated with faster spending growth – but neither of these effects was statistically significant. In marked contrast, greater changes in capital mobility were associated with slower growth in general government consumption. The standard deviation in changes in capital mobility was 0.62. This implies that a one standard deviation increase in this variable would have resulted in a 0.62*-0.16 = 10% decrease in general government consumption between the 1980s and the 1990s. None of the change in market integration terms had any significant effects on changes in total central government spending.

We also estimated the changes equations only for the Latin American countries. Here again, the only significant relationship was the negative effects of changes in capital mobility – and its substantive effect was similar to that estimated for the whole sample.

Thus, when one moves from the analysis of levels of market integration and government spending to changes in these variables in recent decades, support emerges for the widely held view that the growth of capital mobility has significantly constrained public sector expansion.

The Mediating Effects of Democratization

Table 6 asks whether the effects of globalization (i.e. changes in market integration) on the growth or contraction of the public economy was affected by the other important trend in the middle-income countries since 1980 – democratization (changes in Polity scores between the 1980s and 1990s). This was accomplished by including a democratization variable (ΔDemocracy) and its multiplicative interaction with the change in market integration variables. Since this strategy necessarily introduces considerable

collinearity among the regressors, we estimated the democratization-change in integration interaction separately for the three different indicators of market integration. In these equations, the multiplicative interaction term is the most important. Positive and coefficients indicate that the combined effect of democratization and globalization was to increase the pace of government spending growth, whereas negative coefficients would show that the combined effect of these variables was to slow down public sector expansion.

Table 6 about here

The most striking feature of Table 6 is that the bulk of the multiplicative interaction terms are positive and statistically significant. That is, middle-income countries that both globalized and democratized tended between the 1980s and the 1990s to experience more rapid growth in government spending over the same period, with respect both to general government consumption and total central government spending. Using a different indicator of statistical significance – the joint significance of the multiplicative term and its two constituent parts (that is, the change in market integration and change in democracy terms) – also shows that the interaction setup had important statistical effects.

The problem with such interaction specifications, however, is that their substantive effects are difficult to read directly off regression results. To facilitate interpretation, we generated a series of counterfactual estimates of growth or decline in government spending at high and low changes in market integration and democracy. We denoted high as the 90^{th} percentile in the sample distribution, whereas high was set at the

10th percentile. All other variables were set at their means, and estimates of changes in spending were generated (see Tables 7 and 8).

Tables 7 and 8 about here

Consider first Table 7 for general government consumption. This clearly shows that government spending grew fastest in the high-high cells for both trade and foreign direct investment. For a hypothetical country whose change in democracy (i.e. democratization) and change in trade scores were both at the 90th percentile, government consumption is estimated to have increased by 25% between the 1980s and 1990s; for the combination of high democratization and high FDI, the estimated increase in spending was over 47%. These estimates are considerably higher than those in the low change in market integration column, and for the combination of high ΔMarket Integration but low ΔDemocracy.

Things were different, however, for capital mobility. The change in government spending was lower in both cells with high ΔMarket Integration than where this variable was set at the low value – consistent with the negative and significant coefficient on the change in capital mobility term in Table 5. It is true that spending growth was more rapid in countries that democratized more rapidly, but this did not counteract the negative effects of rapid increases in capital mobility.

Table 8 shows even clearer evidence of the positive effects of simultaneous globalization and democratization on the trajectory of government spending – this time, with respect to total central government expenditures. In this case, estimated spending growth was fastest in the three different high-high cases, that is where the change in

democracy variable was interacted separately with changes in trade, FDI and capital mobility.

The bottom line on Tables 6-8 is thus clear. The conjuncture of globalization and democratization in middle-income countries resulted in faster public spending growth, whereas this was less apparent in countries that did not democratize as much between the 1980s and 1990s.

5. CONCLUSION

This paper has explored the relationships among government spending, international market integration, and political regimes in the middle-income countries. Our analysis yields three central findings. First, countries that are more exposed to international markets – not only in terms of exports and imports, but also foreign direct investment and policies affecting cross-border capital flows – tend to have larger public economies. Thus, in the middle-income countries at least, Dani Rodrik's recent finding of a positive relationship between trade and government spending extends to other aspects of market integration as well.

Things are quite different when one moves from levels of market integration (e.g. what portion of GDP does trade constitute in different countries?) to changes in market integration (e.g. how much has trade increased in the past decade?). It is probably fair to say that the contemporary debate is implicitly more about recent changes in market integration than their levels. To take a close to home example, the American policy debate focuses on the fact that trade in the US has increased dramatically in recent years rather than the – equally true – observation that trade remains a very small portion of US GDP.

Moving to the relationship between changes in market integration and changes in government spending generated our second major finding. Countries in which restrictions on cross-border capital movements were more quickly removed from the 1980s to the 1990s experienced considerably slower growth in government spending over these two decades. This is wholly consistent with the view, even endorsed by Rodrik, that increasing capital mobility in recent years has significantly constrained the scope for public sector expansion.

Our third and final important result, however, is that democratization has significantly mediated in globalization-change in government spending dynamics. In countries that became more democratic between the 1980s and 1990s, increasing market integration was associated with much faster growth in government spending – but the converse was true in countries that did not democratize. This reinforces the analysis of Adsera and Boix with respect to the whole world. If democratization and globalization have been the two sweeping changes in middle-income countries since 1980, this has had the consequence of accelerating, rather than retarding public spending growth in these countries.

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Table 1 Government Spending in the 1990s

	General Government Consumption	Total Central Government Spending
Transition		
Albania	15.1	29.8
Belarus	20.5	35.7
Bulgaria	16.5	42.4
Croatia	26.1	41.6
Czech Republic	21	36.1
Estonia	19.9	30.2
Georgia	8.4	9.2
Hungary	11.2	49.9
Kazakhstan	13.1	.
Latvia	18.1	31.1
Lithuania	17.8	26.2
Macedonia, FYR	18.1	.
Poland	18.6	39.7
Romania	13.2	33.5
Russian Federation	15.2	26.6
Slovak Republic	22.5	.
Ukraine	20.4	.
Uzbekistan	22.2	.
Oil Exporters		
Algeria	16.6	31.5
Gabon	14	25.3
Iran, Islamic Rep.	14.2	23.5
Saudi Arabia	29.8	.
Latin America		
Argentina	9.5	13.8
Bolivia	13.1	21
Brazil	18.3	31.9
Chile	9.9	20.8
Colombia	13.7	13.1
Costa Rica	16.9	27.2

Cuba	.	.
Dominican Republic	5.3	14.8
Ecuador	9.9	15.1
El Salvador	9.2	.
Guatemala	5.7	.
Jamaica	14.8	.
Mexico	9.9	15.5
Panama	16.1	25.2
Paraguay	8.5	12
Peru	7.6	15.9
Puerto Rico	14.3	.
Trinidad and Tobago	12.1	28.1
Uruguay	13.3	31
Venezuela, RB*	7.7	19.4
Other		
Botswana	26.4	35.4
Egypt, Arab Rep.	10.5	33.6
Jordan	24.7	33.5
Korea, Rep.	10.4	16.7
Lebanon	16.3	34.3
Libya	.	.
Malaysia	12.4	25.2
Mauritius	11.9	22.6
Mayotte	.	.
Morocco	17	31.1
Namibia	31	37.2
Oman	33.4	38.6
Papua New Guinea	20.1	32.7
Philippines	11.1	18.9
South Africa	19.7	30.6
Sri Lanka	10	27.4
Syrian Arab Republic	13.1	24
Thailand	9.9	16.2
Tunisia	15.3	33.1
Turkey	12	23.2
West Bank and Gaza	20.8	.

Table 2 Market Integration in the 1990s

	Trade / GDP	Capital Mobility (0-9)	FDI (% GDP)
Transition			
Albania	57.4	2.3	0.5
Belarus	.	0.7	.
Bosnia	105.0	1.9	1.3
Bulgaria	86.6	1.0	0.6
Croatia	116.5	0.6	0.1
Czech Republic	94.5	0.8	0.4
Estonia	108.0	3.1	1.3
Georgia	153.7	5.4	2.8
Hungary	70.0	6.9	.
Kazakhstan	73.7	1.3	2.1
Latvia	82.6	0.3	1.6
Lithuania	106.2	7.9	2.2
Macedonia, FYR	106.3	6.1	1.2
Poland	47.5	0.3	1.0
Romania	55.7	0.3	0.4
Russian Federation	53.9	1.7	0.4
Slovak Republic	119.4	0.7	0.8
Ukraine	70.7	0.0	0.3
Uzbekistan	63.4	0.4	.
Yugoslavia, FR	.	0.0	.
Oil Exporters			
Algeria	50.8	0.8	0.0
Gabon	90.0	0.0	7.1
Iran, Islamic Rep.	39.5	0.0	0.0
Iraq	.	0.0	.
Saudi Arabia	77.0	4.4	0.8
Latin America			
Argentina	18.4	6.3	1.5
Bolivia	48.9	4.2	1.9

Brazil	17.6	1.0	0.9
Chile	59.2	1.0	3.2
Colombia	34.8	1.8	1.0
Costa Rica	85.9	5.1	1.8
Dominican Republic	67.9	2.0	1.0
Ecuador	57.3	3.3	1.2
El Salvador	54.0	4.6	0.5
Guatemala	43.2	6.1	1.2
Jamaica	122.2	6.2	2.4
Mexico	47.5	2.3	1.2
Panama	75.9	7.2	3.5
Paraguay	86.4	3.0	0.7
Peru	25.9	4.9	1.5
Trinidad and Tobago	86.7	5.6	4.9
Uruguay	43.4	8.0	0.4
Venezuela, RB	52.8	2.8	1.9
Others			
Botswana	87.5	1.2	2.7
Egypt, Arab Rep.	52.0	3.0	0.5
Jordan	133.0	5.1	0.9
Korea, Rep.	62.9	1.0	0.8
Lebanon	81.1	6.8	.
Libya	.	0.0	.
Malaysia	176.1	1.7	3.1
Mauritius	128.1	6.6	0.5
Morocco	46.8	1.0	0.6
Namibia	114.6	2.0	1.7
Oman	87.9	6.7	.
Papua New Guinea	102.1	2.1	1.5
Philippines	80.6	1.7	0.5
South Africa	43.9	1.4	0.6
Sri Lanka	76.0	1.6	0.3
Syrian Arab Republic	67.2	0.0	0.2
Thailand	84.9	2.6	1.0
Tunisia	89.4	1.0	0.9
Turkey	41.0	2.1	0.3
West Bank and Gaza	88.0	.	.

Table 3. Democracy and Democratization

	Average Polity Score in 1990s
Transition	
Albania	2.7
Belarus	-1.4
Bosnia	-0.6
Bulgaria	6.7
Croatia	0.8
Czech Republic	8.0
Estonia	9.3
Hungary	3.7
Kazakhstan	10.0
Latvia	-0.4
Poland	8.4
Romania	6.0
Russian Federation	4.0
Slovak Republic	7.4
Ukraine	5.7
Uzbekistan	-8.0
Yugoslavia, FR	-6.1
Oil Exporters	
Algeria	-4.1
Gabon	-3.0
Iran, Islamic Rep.	-6.0
Iraq	-8.1
Saudi Arabia	-10.0
Latin America	
Argentina	8.0
Bolivia	9.0
Brazil	8.0
Chile	8.0
Colombia	8.0
Costa Rica	10.0
Cuba	-7.0
Dominican Republic	6.4

Ecuador	8.9
El Salvador	8.8
Guatemala	4.7
Jamaica	9.3
Mexico	2.7
Panama	8.6
Paraguay	5.3
Peru	2.1
Trinidad and Tobago	9.0
Uruguay	10.0
Venezuela, RB	8.2
Other	
Botswana	8.0
Egypt, Arab Rep.	-3.0
Jordan	-3.2
Korea, Rep.	9.2
Libya	-7.0
Malaysia	4.6
Mauritius	10.0
Morocco	-4.1
Namibia	7.7
Oman	-9.2
Papua New Guinea	10.0
Philippines	8.8
South Africa	7.5
Sri Lanka	5.0
Syrian Arab Republic	-9.0
Thailand	7.2
Tunisia	-3.7
Turkey	8.8

Table 4. Integration into International Markets and Size of the Public Economy in the 1990s.

	General Government Consumption	Total Central Government Spending	General Government Consumption (Latin America only)	Total Central Government Spending (Latin America only)
Population	0.20 (1.11)	-0.52 (1.88)	1.92+ (1.15)	2.54 (2.62)
Dependency Ratio	14.42*** (5.41)	5.04 (8.19)	-9.13 (11.94)	-39.58+ (22.08)
Per Capita GDP	1.00** (0.43)	0.44 (0.83)	0.04 (0.89)	0.04 (1.56)
Trade	0.02 (0.05)	0.00 (0.06)	0.12* (0.06)	0.22+ (0.16)
FDI	1.60*** (0.55)	1.60* (0.94)	0.47 (0.67)	0.00 (1.69)
Capital Mobility	0.49+ (0.30)	0.80+ (0.62)	0.59** (0.25)	1.20* (0.61)
Latin America	-4.15** (1.88)	-8.02** (3.11)		
Transition	2.30 (3.52)	16.89*** (5.25)		
Oil Exporters	-0.90 (1.39)	2.52+ (2.27)		
Constant	-2.75 (8.09)	20.66* (12.18)	6.77 (13.73)	30.77+ (20.63)
N	39	35	18	15
R-sq	60.9%	60.2%	43.2%	56.2%

OLS regressions with robust standard errors. *** p < .01; ** .01 < p < .05; * p < .10; + t-ratio > 1.0

The dependent variables are average general government consumption (%GDP) and average total central government expenditures (%GDP), 1990-1998. Trade, FDI, financial integration, (the log of) population, dependency ratio and per capital income all averages for the 1980s. All data from WDI 2000, except the dummy variables which are from Easterly and Yu (1999). Countries with population under one million excluded.

Table 5. Changes in the Size of the Public Economy in Response to Changes in Market Integration.

	General Government Consumption	Total Central Government Spending	General Government Consumption (Latin America only)	Total Central Government Spending (Latin America only)
ΔGDP per capita	-0.55*** (0.18)	-0.39* (0.20)	-0.68* (0.37)	-0.79** (0.36)
ΔTrade	0.21^{+} (0.20)	-0.05 (0.25)	0.39^{+} (0.22)	-0.14 (0.44)
ΔFDI	0.07^{+} (0.06)	0.05 (0.06)	0.08 (0.13)	0.00 (0.08)
ΔCapital Mobility	-0.16** (0.07)	0.00 (0.07)	-0.21** (0.09)	-0.07 (0.09)
Latin America	-0.07 (0.09)	-0.05 (0.10)		
Transition	0.46** (0.22)	-0.26^{+} (0.21)		
Oil Exporter	-0.33*** (0.12)	-0.16** (0.07)		
Constant	0.24** (0.10)	0.18^{+} (0.11)	0.18 (0.22)	0.34* (0.19)
N	34	30	18	15
R-sq	47.2%	21.54%	28.4%	25.67%

OLS regressions with robust standard errors. *** $p < .01$; ** $.01 < p < .05$; * $p < .10$; $^{+}$ t-ratio > 1.0

Change in general government consumption, total central government expenditures, per capita income, trade and FDI all represent the differences of the natural logs of the averages from the 1980s and 1990s. Change in financial integration is the difference in the natural log of 1 plus the average of the 1980s and 1990s. All data from WDI 2000, except the dummy variables which are from Easterly and Yu (1999). Countries with population under one million excluded. Columns 3 and 4 use only Latin American countries.

Table 6. The Mediating Effects of Democratization

	ΔGeneral Government Consumption			ΔTotal Central Government Spending		
ΔGDP	0.25^{+} (0.24)	-0.58*** (0.16)	-0.38* (0.19)	-0.24^{+} (0.18)	-0.49** (0.18)	-0.27+ (0.18)
ΔTrade	-0.17 (0.22)			-0.24^{+} (0.23)		
ΔFDI		0.03 (0.06)			0.00 (0.05)	
ΔCapital Mobility			-0.18** (0.07)			-0.03 (0.07)
ΔDemocracy	0.08 (0.12)	-0.10^{+} (0.08)	0.01 (0.11)	-0.08 (0.08)	-0.12** (0.06)	-0.06 (0.07)
ΔDem*ΔTrade	0.35^{+} (0.34)			0.44* (0.25)		
ΔDem*ΔFDI		0.25*** (0.08)			0.16*** (0.04)	
ΔDem*ΔCM			0.10 (0.19)			0.20** (0.08)
Latin American	-0.01 (0.10)	-0.14* (0.08)	0.04 (0.11)	0.00 (0.07)	-0.05 (0.08)	0.04 (0.09)
Oil Exporter	-0.08 (0.12)	-0.37*** (0.11)	-0.23** (0.10)	-0.07 (0.10)	-0.16** (0.07)	-0.13** (0.05)
Transition	0.25^{+} (.22)	0.61^{+} (0.41)	0.48* (0.27)	0.11+ (0.11)	-0.79*** (0.23)	-0.09 (0.12)
Constant	-.016^{+} (0.14)	0.29*** (0.10)	0.16^{+} (0.14)	0.13+ (0.11)	0.27** (0.12)	0.12^{+} (0.12)
N	45	34	39	36	30	34
R-sq	22.0%	48.0%	40.5%	22.1%	32.8%	18.96%
Joint Sig. of Interaction	30.2%	2.1%	3.6%	40.1%	0.2%	9.2%

OLS regressions with robust standard errors. *** p < .01; ** .01 < p < .05; * p < .10; $^{+}$ t-ratio > 1.0

The change in democracy is coded as the difference in natural logs of the average Polity score for the 1980s and 1990s.

Table 7. Change in Government Consumption at Different Levels of Change in Market Integration and Change in Democracy

		ΔMarket Integration	
		Low	High
ΔDemocracy	Low	Trade: -1.5% FDI: -9.6% CM: +11.2%	Trade: -11.8% FDI: -5.0% CM: -19.0%
	High	Trade: +0.5% FDI: -34.8% CM: +6.5%	Trade: +25.2% FDI: +47.6% CM: -0.7%

Counterfactual estimates derived from Table 9. All variables were set at their means except for the three indicators of market integration (Trade, FDI and capital mobility) and democracy. High (low) values refer to the 90^{th} (10^{th}) percentile in the sample distribution. The values represent % increase or decrease in general government consumption from the average during 1980s to the average in the 1990s.

Table 8. Change in Total Expenditures at Different Levels of Change in Market Integration and Change in Democracy

		ΔMarket Integration: Low	ΔMarket Integration: High
ΔDemocracy	Low	Trade: +6.1% FDI: -0.4% CM: +2.3%	Trade: -9.5% FDI: -1.8% CM: -4.7%
	High	Trade: -15.3% FDI: -25.2% CM: -16.5%	Trade: +8.2% FDI: +18.9% CM: +29.2%

Counterfactual estimates derived from Table 9. All variables were set at their means except for the three indicators of market integration (Trade, FDI and capital mobility) and democracy. High (low) values refer to the 90^{th} (10^{th}) percentile in the sample distribution. The values represent % increase or decrease in total central government expenditure from the average during 1980s to the average in the 1990s.

Figure 1. Government Spending/GDP (%), 1973-1998

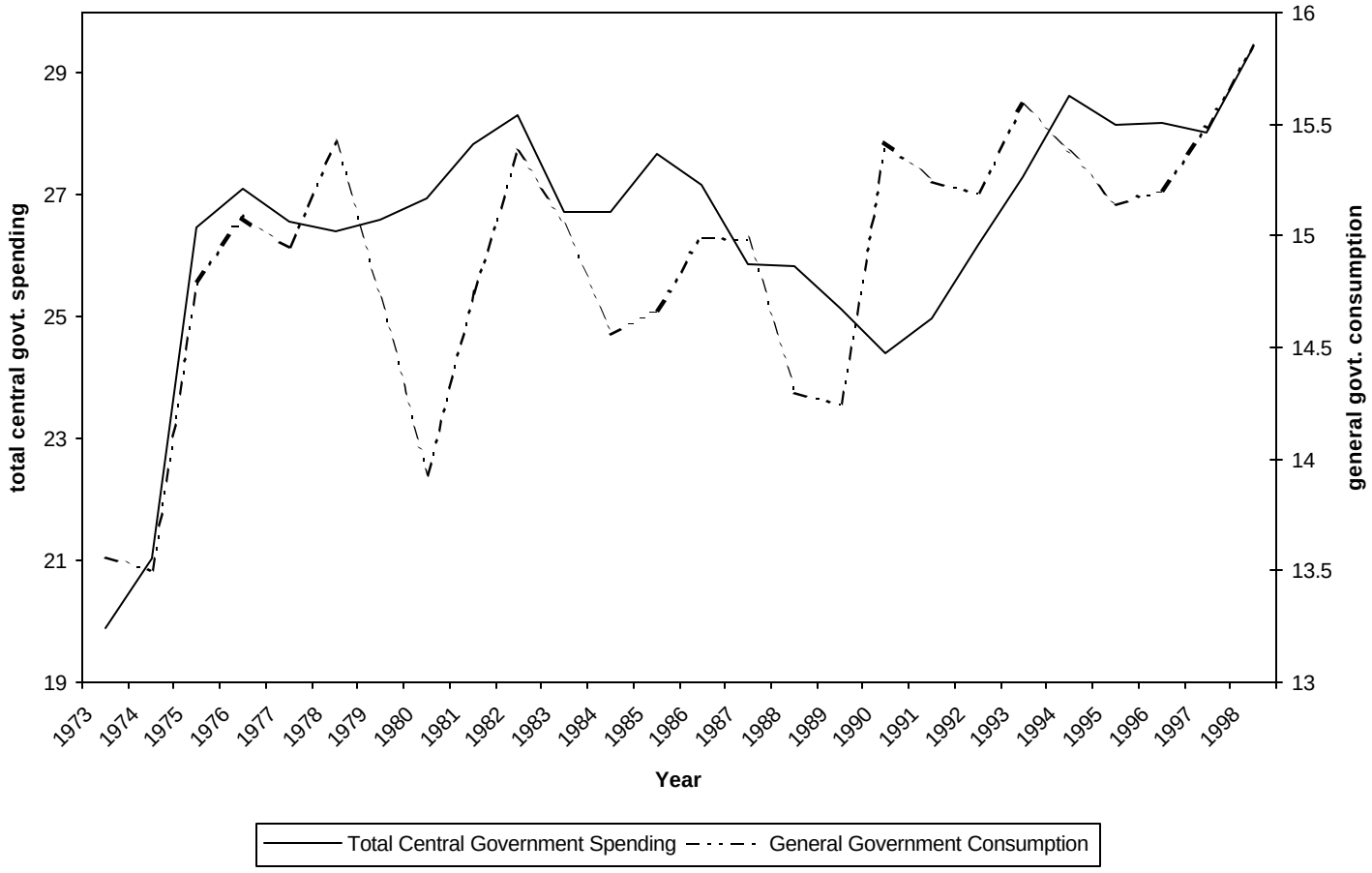


Figure 2. General Government Consumption/GDP (%) by Country Type, 1973-1998

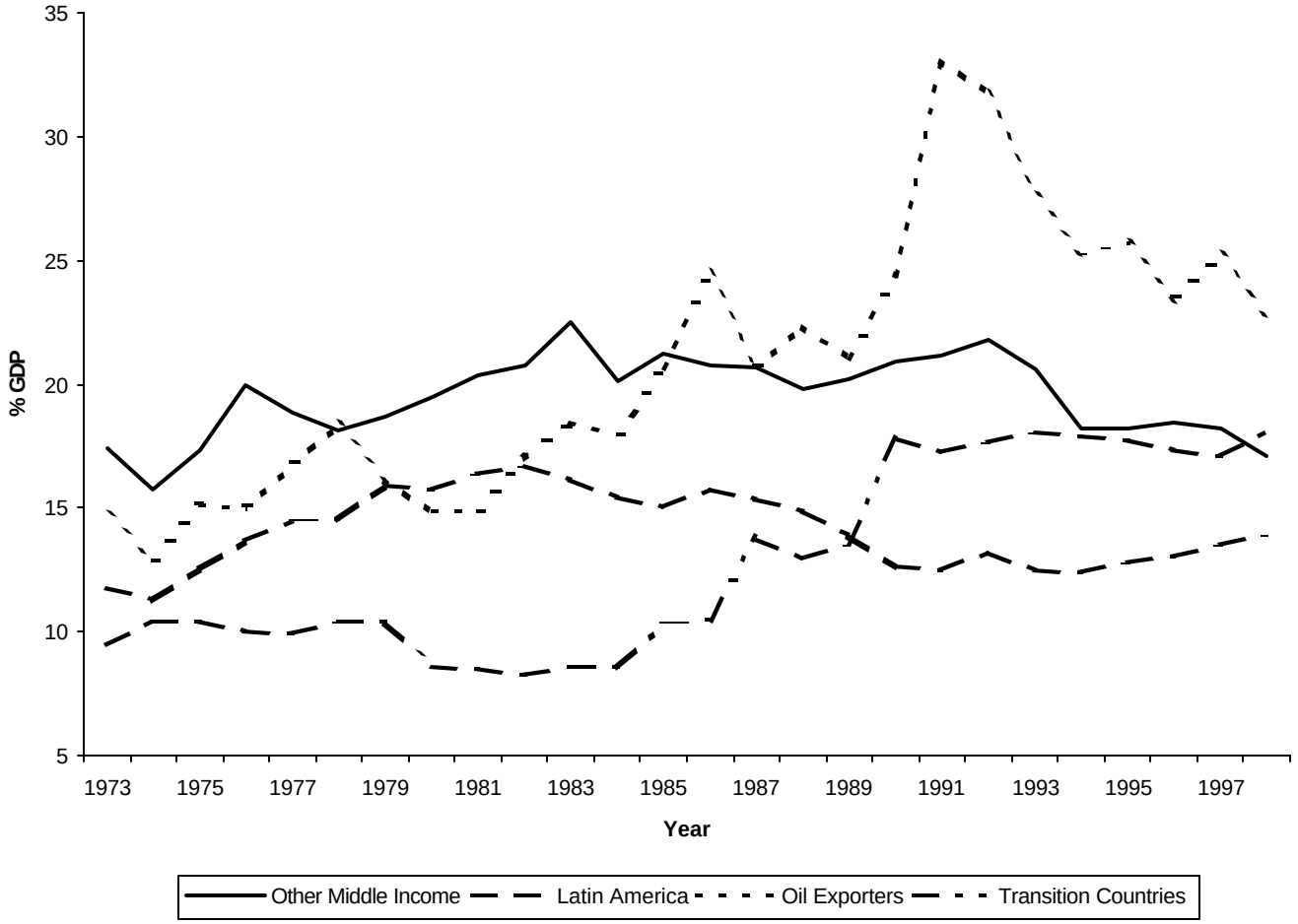


Figure 3. Total Central Government Expenditures/GDP (%) by Country Type, 1973-1998

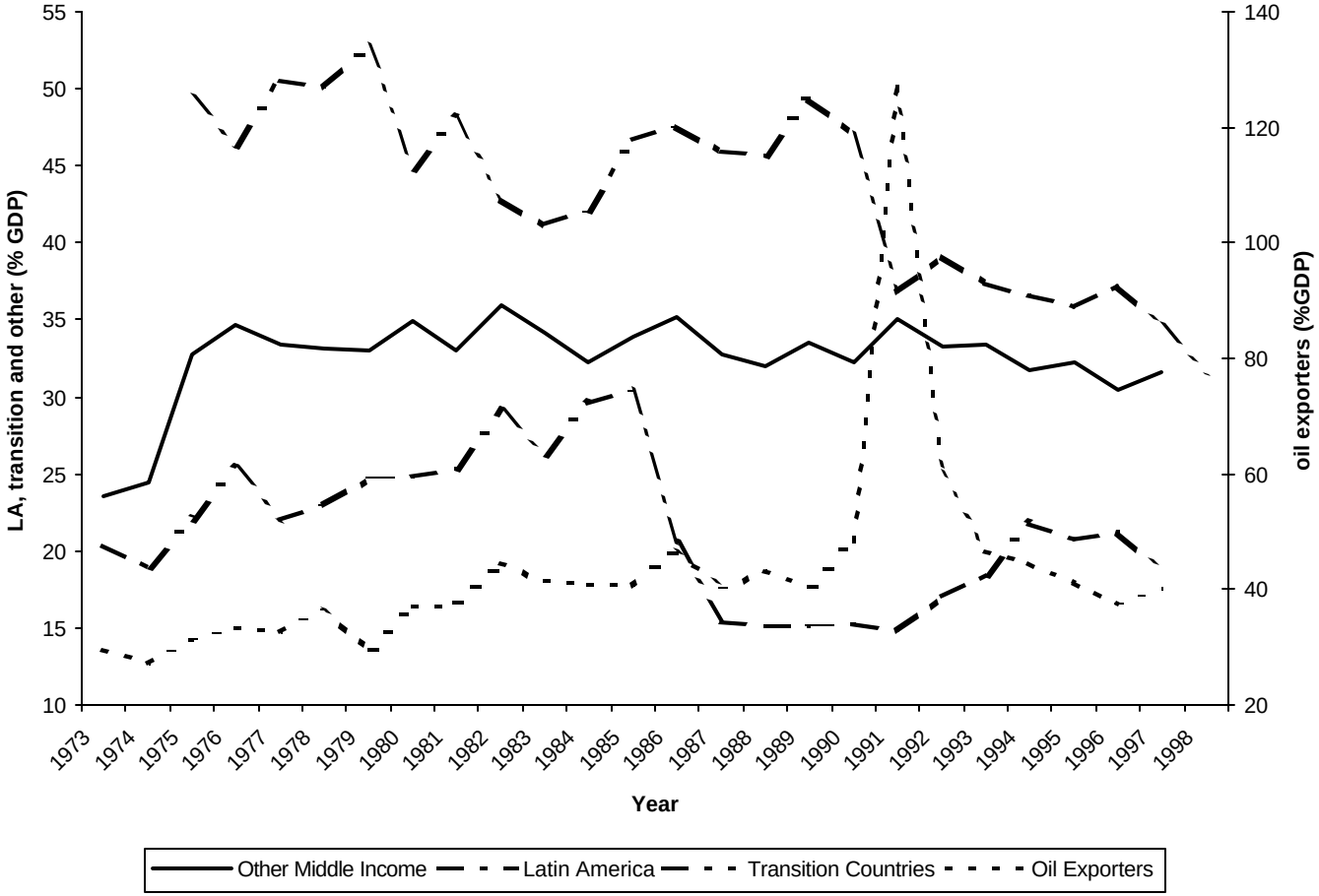


Figure 4. Trade/GDP (%), 1973-1998

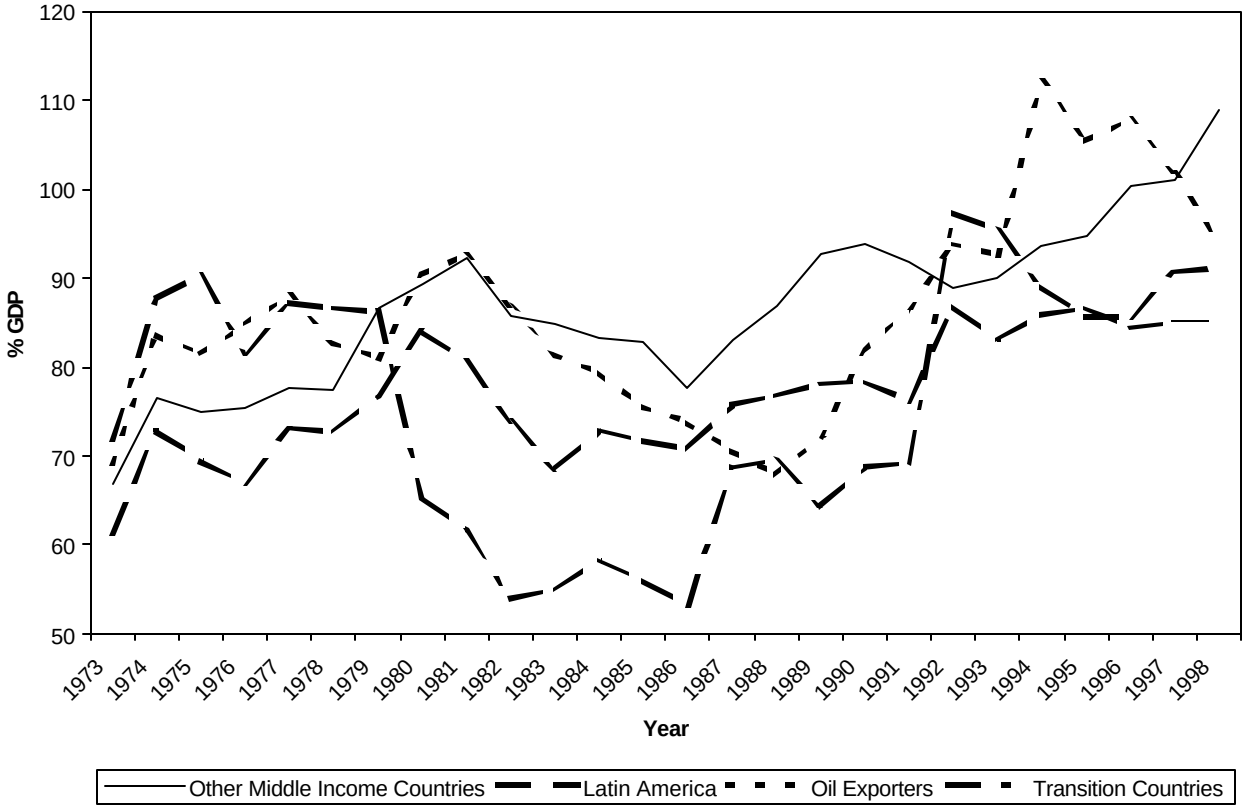


Figure 5. Inflows and Outflows of Foreign Direct Investment/GDP (%), 1975-1998.

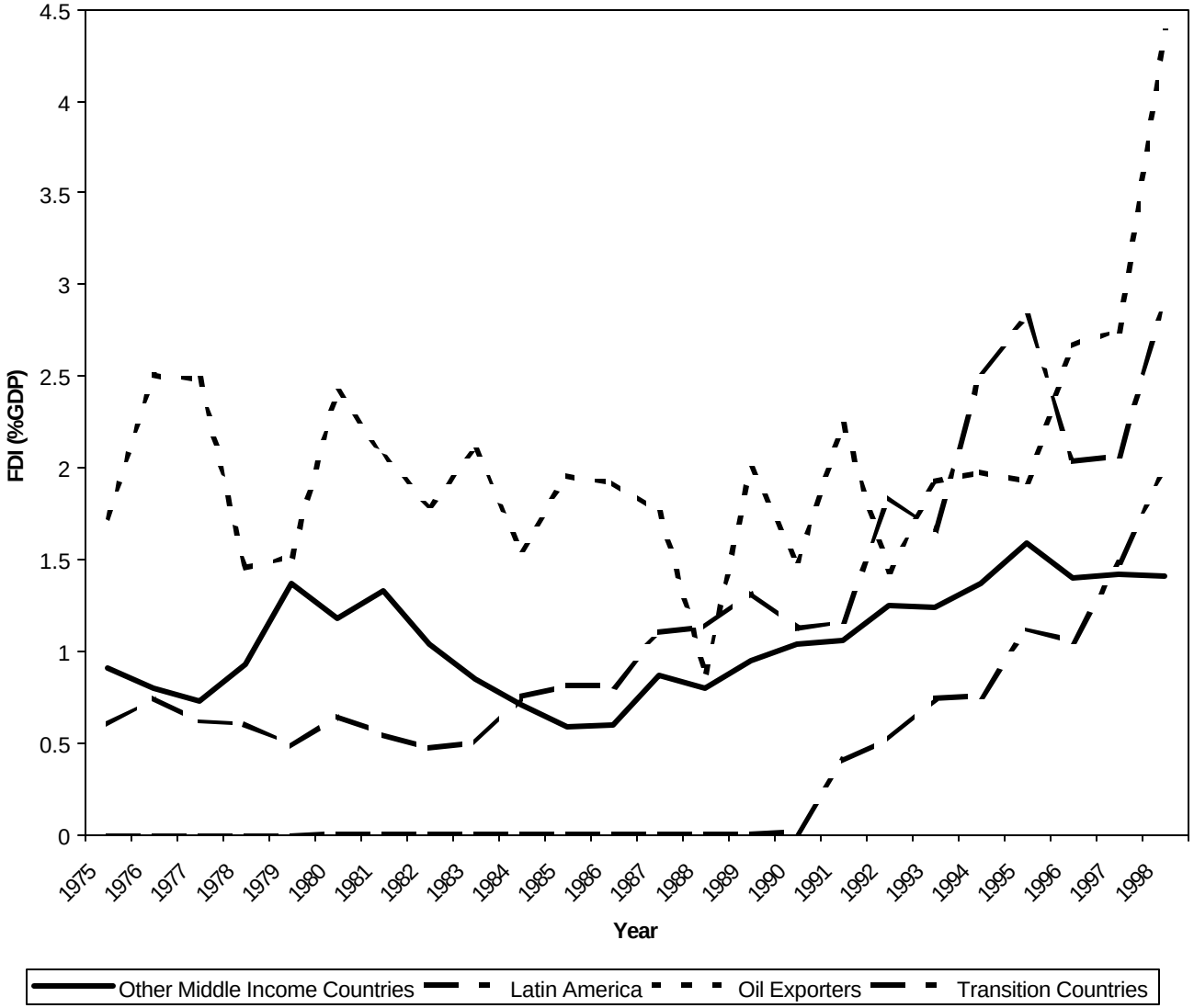
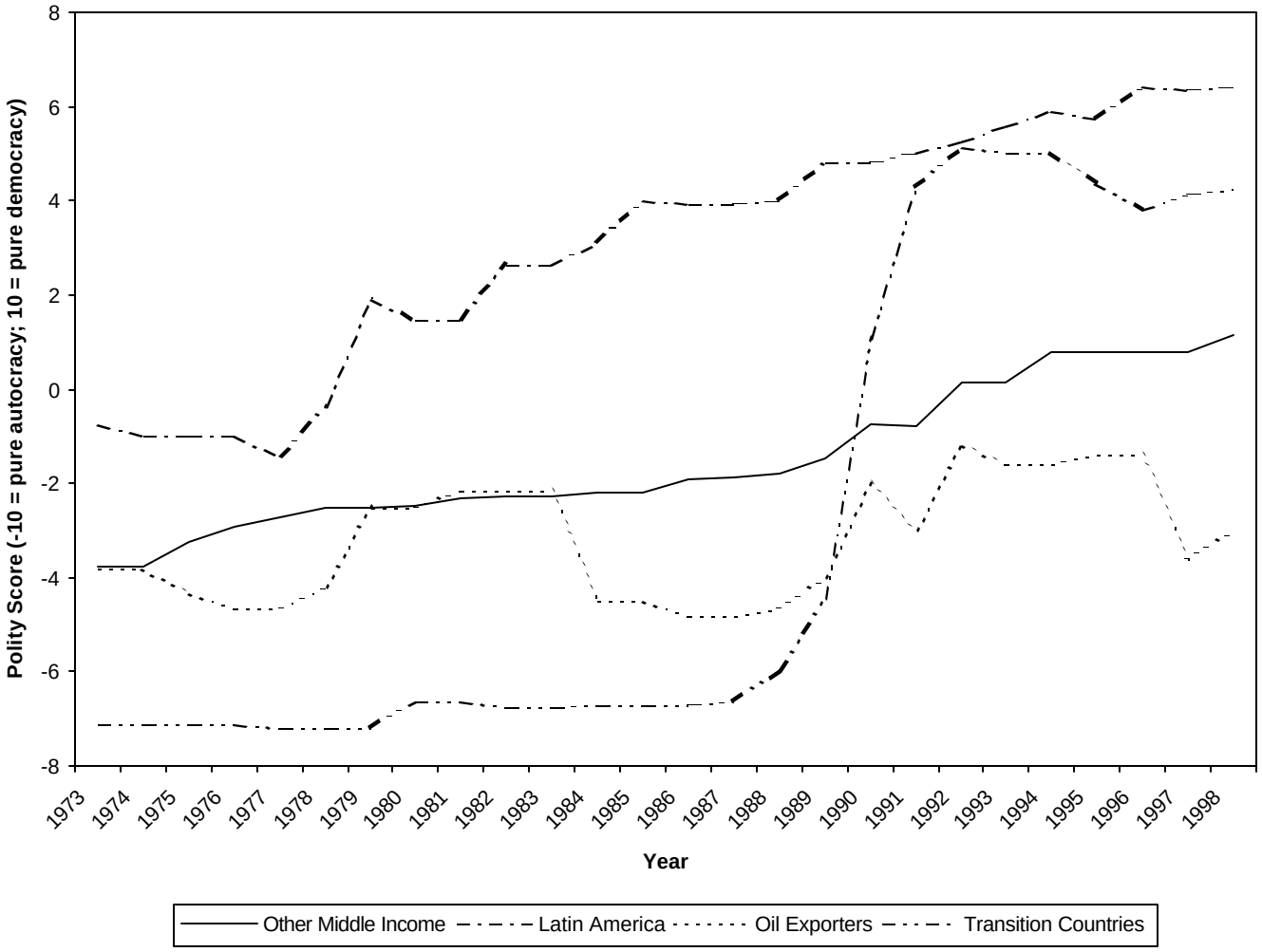


Figure 6. Capital Mobility , 1973-1998

Figure 7. Democratization, 1973-1998.



Endnotes

[1] The World Bank divides countries into four income groups based upon GDP per capita: high income, upper middle income, lower middle income, and low income. We select our cases by combining the upper and lower middle-income groups (see Table 1 for a complete listing).
[2] Garrett (2001b) also finds that globalization has not increased inequality in middle-income countries, perhaps reflecting the fact that less skilled labor is abundant in these countries relative to the OECD. That is, lost manufacturing jobs in the US and Europe have been translated into manufacturing jobs and highe standards of living for workers in middle-income countries.
[3] See Garrett (1998) for a more detailed presentation of these two perspectives.
[4] See Garrett (2000) for a discussion of the causes of globalization.
[5] Hungary would also fall into the big spending group were it not for is low general government consumption score.