

# The public sector and international integration

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## Abstract

How does international integration affect public sector activities? Optimal public sector activities are shown to depend positively on a “gains from trade” effect, and ambiguously on the standard “distortion” effect. The bias in non-cooperative policies may be strengthened by integration.

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## 1. Introduction

It is widely debated whether more international integration or openness implies that public sector activities would have to be expanded or contracted (see e.g. [Rodrik, 1987](#); [Tanzi and Schuknecht, 2000](#) for opposite views). Somewhat paradoxically, the debate seems to be dichotomous since those arguing for retrenchment focus on how international integration affects the scope for tax financing (tax distortions or difficulties in collecting taxes), while those arguing for an expansion focus on the increased demand for public sector activities (demand for more services or need for social insurance).

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With outset in a standard open economy model, this paper considers the basic mechanisms affecting the optimal level of public consumption for a utilitarian policy maker. International integration is modelled as a reduction in trade frictions in product markets, implying that the focus is on product market integration. It is shown that the optimal level of public consumption is affected by a “gains from trade” effect, which is unambiguously positive, and a “distortion” effect, which is ambiguously signed. Obviously, the conditions for absolute retrenchment are stronger than those for relative (public sector relative to private sector activities) retrenchment.

It is well known from the literature that non-cooperative fiscal policies may be too expansionary, i.e. public consumption is expanded more in the non-cooperative case than it would be in the cooperative case. The reason is the so-called terms of trade effect (see e.g. Chari and Kehoe, 1990; Devereux, 1991; Turnovsky, 1988; Van der Ploeg, 1987, 1988). Interestingly, this inefficiency may be reinforced with more integration. That is, contrary to common perceptions, the expansionary bias in public sector activities may be stronger with more integration. Specifically, if the “distortion” effect is strengthened with more integration, it follows that the inefficiency in non-cooperative policy making becomes stronger. This shows that the case for international policy cooperation may be strengthened alongside further international integration.

The paper sets out in Section 2 by developing a basic two country model with public consumption and trade frictions. This section also derives the optimal fiscal policy of a utilitarian government and clarifies the inefficiencies in non-cooperative policy making. Section 3 considers international product market integration reducing trade frictions and its implications for both non-cooperative fiscal policy making and the inefficiencies implied by non-cooperative policy making. Section 5 offers a few concluding remarks.

## 2. Distortions and public sector activities

Consider a non-monetary two country model with specialized production, i.e. each country produces a commodity (bundle) which can be traded internationally. Trade across borders is assumed to be associated with trade frictions implying that one has to buy  $1+\tau$  unit of the foreign good to attain one unit for final consumption, i.e.  $\tau$  measures the friction associated with trade (“iceberg” costs).<sup>1</sup> The process of international integration is taken to lower these trade frictions. To simplify, production is assumed exogenous,<sup>2</sup> and given by  $y$  and  $y^*$ , respectively. In the following,  $*$  indicates foreign variables.

### 2.1. Households

The utility of a representative household is given as the sum of the utility derived from private consumption  $b$  and public consumption  $g$ , i.e.

$$U(b) + V(g) \tag{1}$$

<sup>1</sup> Note that  $\tau$  is a pure friction, and nobody derives any utility from it.

<sup>2</sup> The qualitative results of the paper hold also in the case of endogenous production, cf note available upon request.

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