Investigating the Relationship between Trade Openness and Government Size for Selected South Asian Countries

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Keywords: *Government size, Bureaucratic Efficiency, Trade Openness*

DOI No: https://doi.org/10.56976/jsom.v3i3.104

An essential assumption in the study is that trade openness creates external risk and government increases its expenditures for social protection against externally generated instability. When there are efficient bureaucrats, the size of government reduces to increase the trade openness. Trade openness creates volatility and bureaucratic efficiency may undercut the government consumption. Thus, the government addresses different challenges more efficiently and less costly due to efficient bureaucracy. This paper makes available the empirical evidence of the relationship between trade openness, bureaucratic efficiency and government size.

1 Introduction

Government serves as a central point of attention to policy maker for both developed as well as developing centuries (Aiginger & Rodrik, 2020). The debate between proponents and opponent of openness of markets is still going on (Rosamond, 2020). During the sixteenth and seventeen centuries' Mercantilists believed in the need for government action, whereas classical economist of eighteenth centuries have doubts about government role and believed in productivity of openness of the market system (Kumagai, 2020). After the great depression of 1930s, Keynesian revived the need of government as a regulatory body to overcome market failures (Smith & De Carvalho, 2020). The evidence on theoretical and empirical work by researchers and policy makers still needs the attention, whether government size has a positive or negative effect on trade openness (Christensen, 2021). However, on a broad spectrum, the connection between trade openness and government size is a major subject which has yet not fully understood.

The progressive link between international trade and government size grown mutually and the countries that opened their trade has experienced a significant increase in government expenditures, which has become possible due to effective government size (Côté et al., 2020). Rodrik (1998) solved this puzzle of direct relationship between trade openness and government size by augmenting that government expenditures provides insurance in opposition to the risk of trade openness. Contrary to this, trade openness brings great volatility and insecurity due to competition in international market. In addition, international trade reduces domestic uncertainty to increase trade openness (Kyriazis, 2021). Epifani and Gancia, (2009) investigated that international trade leads to higher risk and volatility. According to this view government increases their expenditures to reduce uncertainty due to trade openness. The aim of discussing trade openness and government size is to give an overview of the recent literature.

2. Reviews of Literature

While introducing bureaucratic efficiency explicitly, trade openness does not support the compensation hypothesis. If it does, it is only valid when bureaucrats performed efficiently, had a catching start to increase, trade openness also entails a reduction of government size. In this regards Alesina and Wacziarg (1997) checked the relationship between government size, which is measured by using consumption as a share of GDP and trade openness. It suggested that more open economies need a large government to play a role against external shocks and empirical results also revealed was a direct relationship between trade openness and government size. By considering government consumption as share of defense, and education as a dependent variable result contemplated that trade openness and the population had an inverse and significant relationship with government consumer. Similarly, by considering total government current expenditure as a dependent variable result showed that trade openness has a direct and significant while population has an insignificant relationship with current government expenditures. The finding of that paper showed that country size has an indirect relationship with government size and trade openness whereas government size and trade openness have a positive relationship.

Cameron (1978) concluded in an empirical study of a sample of 18 OECD countries and found that government size and trade openness are linked positively. However, no significant effort had been made to analyze the link between trade openness and bureaucratic efficiency. Frankel and Romer (1999) concluded the link between trade openness and institutional indicators contribute little in enhancement of trade. Later on they also found that institutions and trade both play a significant critical role in the short run. By adding continental time dummies, trade openness coefficients become insignificant. Anderson and et al (1997) examined and recommended that the trade openness requires more fiscal disciplines. Trade openness extends the process of economic globalization, increasing the ability of states to govern the economy. Trade openness raise the spending of states that have been geared toward the production of human capital and infrastructure, in turn raising the growth rates. Sustainability of public expenditures depends upon the competitive advantage of trade sector and if this competitive advantage wears away than state start shifting toward the protectionist system.

Epifaniy and Ganciaz (2008) premeditated about the relationship between trade openness and the size of government in which trade leads to increase risk and in turn leading to increase public transfers. The findings showed that globalization has a positive association with government size, as the relationship between trade openness and government sizes have found to be positive. Income has been negatively related to government consumption. Term of trade correlation is conditional on the substitution between foreign and domestic goods. Swank (2002) studied about the relationship between trade openness and public spending and in this study public spending is subdivided into social welfare programs, unemployment compensations and government spending on health programs. The results of this research showed significant associations between trade openness and social welfare programs. There will be strong effect of globalization on institutional structure and social welfare was strongly affected by public spending. Stroup and Zissimos (2010) also explored the idea in which inverse relationship between size if government and trade openness may lead to social unrest. The Government has direct control of the size of pampered bureaucracy and similarly openness has the positive impact on the size of government.

Aydogus and Topcu (2013) studied an investigation of co-Integration and causality between trade openness and government size for the time period 1974-2011.The main lesson of this study is that there is the direct and significant relationship between trade openness, size of government and a unidirectional causality exists between trade openness and government size. On the same lines, Liberati (2013) studied the relationship between trade openness and government size using a panel of countries for the time period 1962-2009. Positive relationship between trade openness and government size is confirmed when the population variable is excluded from the equation as the result showed that the relationship between trade openness and government exist, when country size is omitted from the framework. Angelopoulos et al. (2008) estimated the effect of government size on growth that depends upon the efficiency of the public sector, by using 2SLS and Ordinary Least Square (OLS) for a panel study of developed and developing countries. The results show that public sector efficiency has a positive effect on government size and economic growth

3. Data Description

Data for Size of Government (GS) and trade openness (TO) is obtained from World Development Indicators (World Bank 2017) online data base. Size of government is measured by government consumption as a percentage of GDP. Government size is in natural log form. Size of government is used as the dependent variable. Trade openness is obtained by dividing the total trade by gross domestic product. Bureaucratic efficiency (BE) is measured by government effectiveness, takes values between -2.5 (week) and 2.5 (strong). In this study, government effectiveness is used as a proxy of bureaucratic efficiency because this index spans over a long time period and it also covers a large number of countries. Our data sample consists of four major SAARC countries. The variables used in this study are: trade openness (TO), bureaucratic efficiency (BE), and government size (GS).

4 Analysis

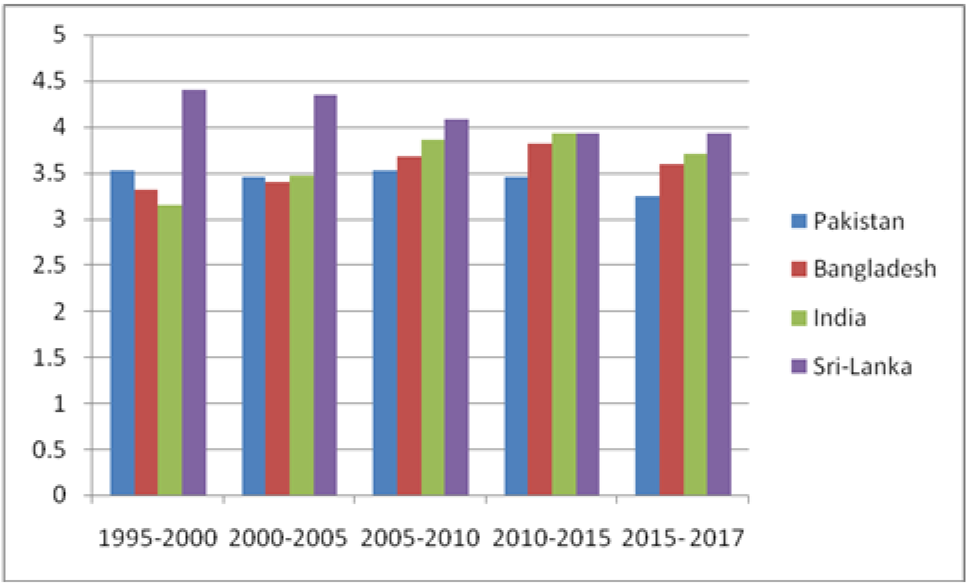
4.1 Trends of Trade Openness

Trade is the instrument of development, the trade performance of India, Sri-Lanka, Pakistan and Bangladesh has remained disappointing. The combined trade of all member countries makes up less than 2% of total world trade. Data on trade openness has been plotted for the sample countries in the figure 2.1 given below. This figure reports that there are unparalleled differences among the countries, where Srilanka showing a sharp increase in trade openness compared to other countries and remained on the top. Next to Srilanka, India a persistent increase and remained in the second highest position on the basis of the level of trade openness. Rest of all other countries showed mixed trends in trade openness.

Trade openness of Pakistan increased gradually till 2010 and subsequently showed a declining trend. During 1980s import quota on capital goods was reduced and restriction was imposed on luxury goods. During 1990s, the government introduced tariff reforms policy to increase exports and industrial production. In 2000s export led policy was introduced by keeping the interest of the upper-class community. Trade policies are not successful in increasing trade volume in India because of governance issues and bureaucratic inefficiency. Bangladesh is situated at a strategic point to get in touch with into two largest markets China and India. Bangladesh also gets benefit from duty and quota free trade access mainly in the European Union markets. Bangladesh has a bilateral agreement to keep away from double taxation with 28 countries.

In 1991 India has opened its market for world to promote international competition to achieve standards of growth. During 1997 to 2002 a new concept of trade policy was introduced in which 542 items had been provided with a special import license and free import list. During 2002 to 2009 Indian banks were allowed to set up special economic zone to attract foreign investment.

Figure No 1: Trend of Trade Openness



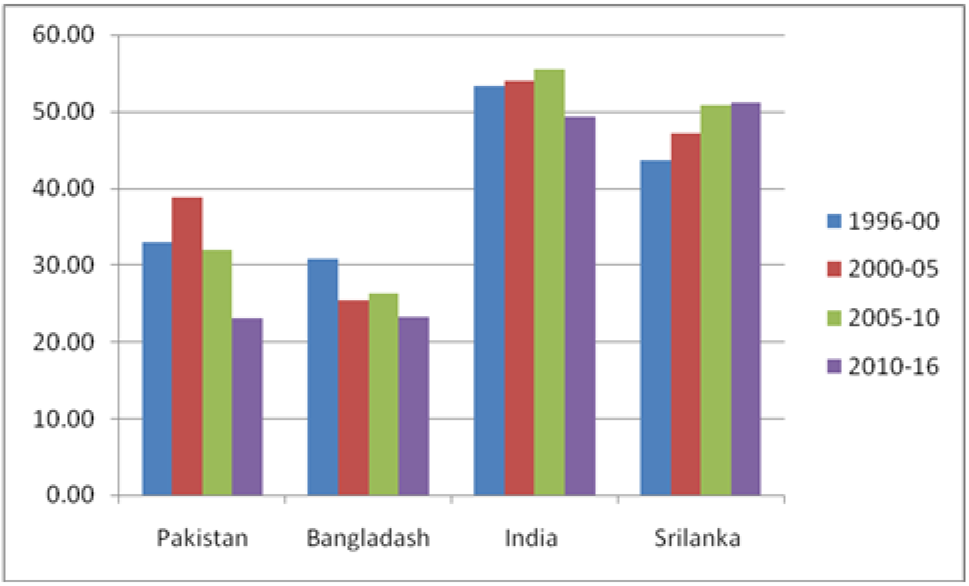
Source: World development indicator and averages taken by author

In this way different trade policies were announced to attract foreign investors and to enhance exports. Trade liberalization was the hallmark of Sri-Lankan liberalization reforms. Sri-Lanka developed the Greater Colombo Economic Commission in 1978 with power to operate FTZs. The investment promotion policy offered by Sri-Lanka to FTZ investor was more attractive, than incentive packages of FTZs of most other countries. During 1997 all textile tariffs were abolished with a view to providing a free trade regime. After tax incentives given by the BOI , have become highly politicized in the last decade due to which Sri -Lanka exports contracted by 5.4% in 2015, and top three export products of Sri –Lanka, contributed for 86% to decline.

4.2 Trends of Bureaucratic Efficiency in Selected SAARC Countries

Data on bureaucracy has been plotted for the sample countries in Fig 2.2. This report that there are unparalleled difference among the countries, where Srilanka showed a sharp increase in bureaucratic quality as compared to other countries and remained on the top. Contrary to this, India persistently increased the bureaucratic quality till 2000-10 and then showed a declining trend till 2015. Bureaucratic quality of Pakistan increased gradually, till 2005 and afterward showed a declining trend.

Figure No 2: Trend of Bureaucratic Efficiency



Source: World Governance indicator and averages taken by author

The structure of the Bureaucracy in Pakistan has been affected by the varying military laws and uncertain political setups. The ruling governments of Pakistan failed to grasp the significance of a free and sparkling bureaucracy for a country's economic growth; they constantly mistreated their power and pampered in matters which yielded private gains. The bureaucracy was being commonly used to provide private gains by illegal ways (Shafqat, 1999). The bureaucracy in Pakistan has seemed up to be highly indulged in gains by illegal ways, behavior and this has led to diminish growth of the country. In the Pakistan bureaucracy context, growth rates have been highly affected. It has been a key source of hammering of foreign financial investment in Pakistan. For Bangladesh figure shows the declining trend of bureaucracy as the bureaucracy of Bangladesh is not competent in supervision and administration. Bureaucratic inefficiency takes place due to lack of bureaucratic accountability and this happened due to ineffective means to make bureaucrats answerable and transparent.

Performance of bureaucracy can be measured by one institution that is customs, which is interested in implementing trade and other commercial policies. The popular perception is that in India bureaucracy has become more politicized and more corrupt. The short outcome of Krishnan and Somanathan (2005) is that "the current state of civil services leaves much to be desired". International understanding shows that countries that have effectively applied restructuring programs across a number of areas have several features in common: strong leadership, clear accountability mechanisms, an inclusive institutional setup, efficient bureaucracy and detailed implementation plans with measurable goals which are monitored. Similarly, in Sri-Lanka due to clear accountability mechanism, bureaucrats performed efficiently and implement the plans to achieve the goals.

4.3 Trends of Government Consumption

Data on government size has been plotted for the sample countries in Fig 2.3. The report shows that there are unparalleled differences among the countries. Sri- Lanka showed sharply increased in government consumption level till 2010, and showed a decreasing trend till 2017. India remained on the second highest position and Bangladesh is at the lowest position in consumption level.

Figure No 3: Trend of Government Consumption

Source: World development Indicator 2017

The Government provides basic needs such as law and order, defense, create social and economic infrastructure. There are two types of expenditures, current expenditures and public investment. Current expenditure is the type of expenditures which is used to meet the cost of basic administrative services, whereas public investment expenditures are based on the provision of infrastructure such as roads, telecommunication bridges, research and development. The government of Sri-Lanka contributed the trend of recent years of adding the government expenditures to growth and the important factor is preventing the economy from contracting. The outlook of Sri-Lankan economy is positive and economy expands 5% in 2016.In Sri-Lanka consumption expenditures were slower due to tight monetary and fiscal policy, whereas government expenditures of Sri-Lanka on machinery and equipment grew by 6.8% in 2015. The Indian government took benefit of low oil prices and eliminates diesel subsidies and raised excise duties on petrol and diesel. To control the fiscal deficit Indian government cut down the planned expenditures to various ministries and department and increased priority to development expenditures which further increase the economic growth. In India 16% to 23 % increase in public wages and pensions, increased central government spending by an estimated 0.4% of GDP during 2016-17.

Spending precedence has also been given to raising infrastructure and rural sector. The Indian government also finances large investment projects through receipt from privatization and also from off budget. Indian fiscal deficit declines from 4.9% to 3.9% during 2012 to 2016. Pakistan economy since its creation suffered from fiscal imbalances that is government spending supersedes revenues. The widening gap between spending and revenue, raise the Pakistani economy debt. It is observed that despite several attempts to reduce the development expenditures the fiscal deficit was high in the period of 1990s.

5. Conclusions

The above four economies are of critical importance for any sub regional integration, to operate successfully. India and Pakistan would be the dominant constituents of any formal regional integration agreement. From Above discussion, we conclude that our sample countries started switching towards openness later than other regions of the world. Therefore, this region suffers from bureaucratic inefficiencies, corruption and heavy fiscal deficit due to non-development government expenditures. The study added to this discussion by highlighting that the outcome of government size is inclined by the performance of bureaucrats. In other words, the bureaucratic efficiency perspective must be taken into account; otherwise, it would be confusing to defend the effect of government size on trade openness across countries. When bureaucratic efficiency is low, then the government will increase its size of expenditures to increase the trade openness and when bureaucratic excellence is high, the extent of government size does not come into view to trade openness restrain. It is important to think about that economic policy about government size and trade openness cannot be reviewed regardless of the bureaucratic performance viewpoint.

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