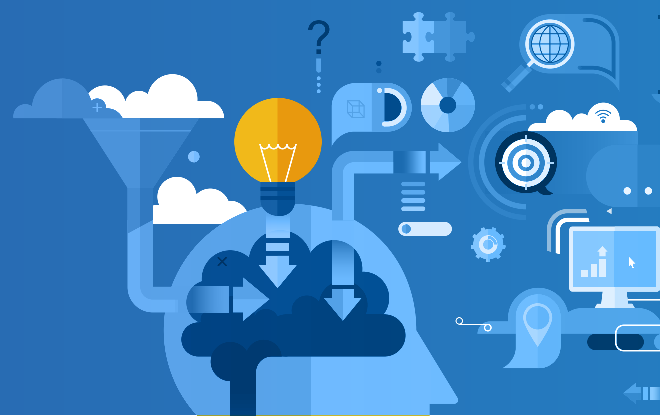
RESEARCH INSIGHTS



IDB

What Is the Role of State Capacity in Dealing with Macroeconomic Volatility?

- Macroeconomic volatility can have serious implications for the economy; reducing a country's exposure can increase long-term prosperity.
- When the government has significant capabilities, it is not necessary to isolate the economy using an inefficient technology: a large public sector that reduces the transmission of the shock in the economy.
- The effect of economic openness on government spending is mediated by the quality of government institutions. Countries must therefore invest in their capacities to face more effectively the challenges of external shocks. These capabilities are not developed overnight but instead result from continuous actions over time.

CONTEXT

In order to manage external shocks induced by trade openness, such as those involving terms of trade volatility, governments resort to a variety of measures. One approach is to increase the size of the public sector in order to insulate a significant part of the economy from shocks. The compensation hypothesis argues that a higher level of trade openness leads to greater exposure to external risk and, therefore, expanding the government's economic role by means such as increasing public sector employment—helps to reduce the level of exposure. That approach, however, can slow economic growth.

Key Concept

STATE CAPACITY

The government's ability to implement public policies, which depends on the capacity of its bureaucracy, the institutional strength of the legislature and political parties, and the independence of the judiciary.

PROJECT

While findings to date have supported the compensation hypothesis, the existing analysis does not take into account that different government capabilities allow for different policy instruments. More capable governments can use flexible exchange rates, countercyclical fiscal policy, or finance themselves in deep internal financial sectors. Therefore, the validity of the compensation hypothesis may depend on government capabilities. This project therefore examines whether the connection between trade openness and public spending depends on government capabilities. The objective is not to discuss the level of public spending, however, but rather the relationship between exposure to external risk and the size of government.

RESULTS

In the absence of including bureaucratic capabilities (the available measure of government capabilities) in the empirical analysis, openness has a large, positive and significant effect on public spending, supporting the compensation hypothesis. A 10-percentage point (pp) increase in the share of total trade in GDP is associated with a 5% increase in the share of public spending in GDP.

However, countries differ in their capacities to implement policies and how they respond to increased external risk. Those with higher capabilities do not need to use public spending as a tool to isolate the economy from external shocks. If that is the case, then the correlation between openness and government size would only hold for low levels of bureaucratic capacity and disappear for higher levels. That is what is shown in the data. As can be observed in the figure 1, the interaction between openness and bureaucratic quality is negative and significant. In other words, openness has a positive effect, but this tends to be attenuated by higher levels of bureaucratic capabilities. The effect of openness on size becomes insignificant around the mean of the distribution. In other words, openness has a positive effect on government consumption for those countries with a bureaucratic quality score approximately below 2.2 out of 4 points (such as Sierra Leone) and no effect for countries on the higher end of the distribution (such as Canada and Germany).

Key Concept

COMPENSATION HYPOTHESIS

The hypothesis that the government's attempt to compensate for the risks of trade openness results in a positive correlation between trade openness and the size of the public sector.

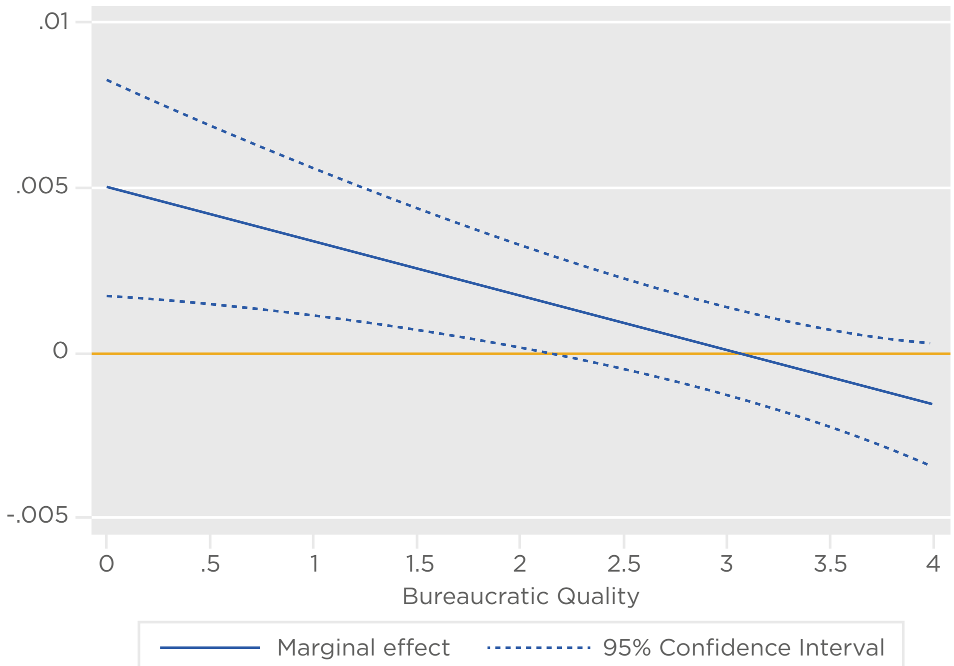
POLICY IMPLICATIONS

The quality of political institutions and state capacity define a country's economic development. It is therefore of utmost importance to increase governmental capabilities. These capabilities do not evolve overnight, and they cannot be built by decree by drafting an institutional reform law; rather, they are the result of the actions of the country's main political actors over time. Increasing government capabilities implies strengthening the legislatures, strengthening the judiciary and promoting its independence, strengthening public agencies, promoting professionalization and some degree of accountable autonomy and independence, and strengthening political parties by fostering their programmatic capabilities and their national orientation.

To achieve these objectives, policymakers must undertake the following actions. First, they must protect institutions from political manipulation by the Executive of the day and create incentives for investing in their its development rather than focusing on short-term capital investments (such as "buying them computers"). Second, they must consider the main incentives of key players because they are much more important than the rules regulating more detailed behaviors, such as civil service laws. Even copying the best civil service laws in the world will not generate a more capable state if the incentives of elected officials are not well aligned. Third, policymakers should refuse to be accomplices in capacity destruction. Finally, they should accept "middle-of-the-road" solutions that are more likely to be sustained.

With increased government capacity, countries could address the challenges of trade liberalization with social, fiscal, macroeconomic, and microeconomic policies that are less costly and more efficient than simply increasing public employment. For example, countries with greater capacity can use flexible exchange rates to introduce fiscal rules that reduce the procyclicality of spending. They also have access to capital markets that can help mitigate and better manage macroeconomic volatility.

Figure 1. Marginal Effect of Trade Openness on Government Consumption along Bureaucratic Quality: Cross Section



Note: The figure corresponds to the regression in column 2 of Table 1.

IDB RESEARCH ON GOVERNMENTAL CAPABILITIES

At the IDB, we understand that countries need governmental capabilities to achieve public policies that promote sustainable and inclusive growth. Therefore, we have developed an extensive knowledge agenda on the causes and consequences of low governance capabilities and on the reforms needed to increase them.

FULL STUDY

Franco Chuaire, María, Carlos Scartascini, and Mariano Tommasi. 2017. "State Capacity and the Quality of Policies. Revisiting the Relationship between Openness and Government Size." *Economics & Politics* 29 (2): 133–56.

This study was also published as an IDB Working Paper.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

Authors: Maria Franco Chuaire, Carlos Scartascini, and Mariano Tommasi.

IDB