

Discussion of Gino Gancia's

“On Globalization and the
Growth of Governments”

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Overview

- Why governments?
 - Market failure in the provision of public goods.
 - Market failure in the provision of insurance (private information).
- **Key Idea:** Optimal size of government intervention may be a function of trade integration:
 - Channel 1: Domestic cost of public good provision is decreasing in trade integration.
 - Channel 2: Trade integration increases the demand for public insurance
- A key parameter shapes these two channels differentially, so there is hope of empirically disentangling them.
- Empirical evidence suggests that Channel 1 is more relevant (policy).

Preliminaries to Channel 1

- Optimal Tariff Argument: “Sufficiently large” countries have an incentive to levy import tariffs or export taxes and shift the terms of trade in their favor.
- It is not really about “big” or “small,” but about the elasticity of a country’s demand for their exports.
- In a world with homogenous goods, a small country faces a perfectly elastic export demand function ($t^* = 0$).
- But a negligibly small country producing a differentiated good still may have market power. The higher the degree of differentiation (the lower the elasticity of substitution σ between domestic and foreign goods), the larger t^* .

Channel 1

- In deciding on the provision of public goods, the social planner equates the marginal benefit (utility) of G and its marginal cost (lower provision of private goods).
- In a negligible open economy with market power, the cost of the crowding out effect is smaller because as the supply of exportables falls, their price increases (effect governed by σ).
 - Note: Size still matters because world price of imported goods is held constant, ensuring that terms of trade improve.
- The larger the importance of exportables in total domestic production (the larger τ), the lower is the cost provision of G and the larger is the size of the government.
- The impact of an increase in τ on G decreasing in σ .

Channel 2

- In a closed economy, changes in relative prices across sectors provide insurance against productivity shocks.
- In an open economy, prices are set in world markets and therefore “self-insurance” is attenuated.
- The loss of self-insurance (i.e., the larger need for public insurance) is a function of openness and substitutability.
- When goods are perfect substitutes, prices do not adjust at all, hence need for insurance is maximal. In the Cobb-Douglas case, no need for insurance.
- Overall, the impact of τ on G is positive, and the effect is increasing in σ .

Empirics

- Controlling for a set of covariates, trade shares are positively correlated with the ratio of government consumption/GDP, but not with government transfers/GDP → TOT 1 - Insurance 0.
- Countries that grow faster see their terms of trade deteriorate → TOT 2 - Insurance 0.
- Correlation between τ and g has increased through time (when σ has gone down) → TOT 3 - Insurance 0.
- Correlation between τ and g is higher for countries where σ appears to be lower → TOT 4 - Insurance 0.

Comments

- This is a GREAT paper. Model is neat and elegant; lots of work in the empirical section.
- But I have to do my job....
- Comments on the Theory
 - Relevance of Terms of Trade Effects for Policy Determination
 - Potential Extensions
- Comments on the Empirics

Comments on the Theory

- If countries have the ability to affect world prices, why don't we see countries use export taxes more widely?
 - Appendix to the paper derives a testable implication of the model (a positive export tax) that seems grossly counterfactual.
 - Note that GATT/WTO restrict import tariffs, not export taxes.
- This suggests that other forces (i.e., political economy forces) may be more important in shaping the structure of protection.
 - Grossman and Helpman (1994) derive optimal import tariffs and export subsidies in a SOE model.
- Seem plausible that political economy forces could also drive the correlation between τ and g .

Comments on the Theory (2)

- Nice separation between optimal trade taxes and labor taxes to finance public goods (see also, Boadway et al., JPubE, 1973).
- But in a few countries, trade taxes account for a big fraction of the way g is financed. Easy to adapt model to this scenario. Could this help explain correlations in the data? It appears not...
- Alternative way to model globalization: a fraction τ of all goods melts when transitting across borders – does not seem to work so nicely.
- Not a big fan of Benassy term in CES consumption aggregates – but here does not seem to play any role.

Comments on the Empirics

- Nice collection of “moments in the data” that seem consistent with predictions from the model.
- Try to move beyond correlations and explore the mechanism in the paper.
- Worry: third factors driving correlation (e.g., improvements in ICTs).
- Solution: Instrumental variables. Easy to find Z such that $E(\tau, Z) \neq 0$. Big payoff to finding a determinant of trade shares that plausibly affects g only through τ .
 - Frankel and Romer suggest geography. Not clear it is fully satisfactory, but it’s worth trying – time dimension may be problematic.

Comments on the Empirics (II): Data Issues

- Robustness to other measures of relative size of government (relative employment).
- Use new country-level Broda and Weinstein measures of σ .
- Is it obvious that what matters is the own country τ ? Effect of g on world prices will likely depend on multilateral “openness” measures.
- Not obvious that terms-of-trade variability relates to need for insurance in the model (different source of uncertainty).