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Globalization, fractionalized governments and expansionary fiscal policy

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Abstract

Purpose – As a response to challenges that globalization poses, governments often utilize an expansionary fiscal policy, a mix of increased compensation spending and capital tax cuts. To account for these policy measures that are consistent with neither the compensation nor the efficiency hypothesis, this study examines government fractionalization as the key conditional factor.

Design/methodology/approach – We test our hypothesis with a country-year data covering 24 OECD countries from 1980 to 2011. To examine how a single country juggles compensation spending and capital taxation policies jointly, we employ a research strategy that classifies governments into four categories based on their implementation of the two policies and examine the link between imports and fiscal policy choices conditioned on government fractionalization.

Findings – This study shows that highly fractionalized governments are more likely to implement an expansionary fiscal policy than marginally fractionalized governments as a policy response to economic globalization and import shock.

Social implications – Our findings imply that fractionalized governments are likely to face budget deficits and debt crises, as the expansionary fiscal policy persists over time.

Originality/value – By examining government fractionalization as one of the critical factors that constrain the fiscal policy choice, this study enhances our understanding of the relationship between economic globalization and compensation or efficiency policies. The arguments and findings in this study explain why governments utilize the seeming incompatible policy preferences over increased compensation spending and reduced capital tax burdens as a response to globalization, potentially subsuming both hypotheses.

Keywords Globalization, Government fractionalization, Compensation, Capital taxation

Paper type Research paper

Introduction

As the level of economic globalization deepens and challenges it poses to national economies are intensified, scholars have actively debated whether governments focus on the compensation of losers of globalization or the promotion of competitiveness of their economies as a primary response to globalization. A puzzling observation is that governments often implement a policy of compensation spending and capital taxation that

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is not fully consistent with either the compensation hypothesis or the efficiency hypothesis, the two main arguments for governments' responses to globalization.

The compensation hypothesis posits that governments increase social spending to compensate losers and minimize negative consequences globalization incurs to them (Avelino *et al.*, 2005; Hays *et al.*, 2005; Hwang and Lee, 2014). The efficiency hypothesis, on the other hand, explains that governments' key focus lies in the promotion of international competitiveness of their domestic firms and thus favor business-friendly capital taxation policy. A fiscal policy that is designed to achieve these two goals simultaneously can result in a mismatch between revenues and expenses. Therefore, this expansionary fiscal policy may induce unbalanced budget problems and debt crises for countries that heavily engage in international trade and economic globalization (Avi-Yonah, 2019; Genschel, 2002). Despite the seeming incompatible policy preferences over compensation spending and capital taxation and its threat to fiscal risk, it is not clear under what conditions governments are likely to implement this expansionary fiscal policy.

In this regard, this study contributes to the related literature in two ways. First, it examines how a country puts compensation spending and capital taxation policy measures together and whether the policy implementation is consistent with either the compensation or the efficiency hypothesis. By categorizing countries with multiple combinations of these two policy measures, this study explores how governments use different fiscal policy responses to globalization. Second, as a key factor that explains the adoption of an expansionary fiscal policy, this study examines government fractionalization. When governments are highly fractionalized, due to the need to satisfy broad audience and multiple veto-players, they are likely to favor an expansionary fiscal policy with limited concerns about its negative impact on the economy and fiscal risk. The theoretical argument and empirical findings in this study potentially subsume both hypotheses and implicitly provide an explanation for why debt crises occur in some countries in the era of globalization.

Globalization, compensation spending and capital taxation

The compensation hypothesis postulates that governments establish various compensation programs that target losers of globalization for the purpose of maintaining support for open economy policies and/or reduce their discontent and complaints with globalization policies (Adserà and Boix, 2002; Menendez, 2016). For example, Rodrik (1998) reports that high levels of international trade induce increased government spending. Avelino *et al.* (2005) find that trade integration is positively associated with an expansion of education and social security programs. Similarly, Hays and his colleagues (2005) demonstrate that increases in imports promote government-administered programs including unemployment insurance and various labor market programs, which aim to shield those adversely affected by global integration. Furthering this line of inquiry, Cao *et al.* (2007) and Hwang and Lee (2014) argue that both industrial subsidies and welfare spending can be used as compensation tools and examine how government ideology is associated with their policy choice. Tax policies and programs can also be used for the compensatory purpose. When most capital owners are winners of economic integration, for example, governments may strengthen progressive taxation systems that promote redistribution of wealth, and shift taxation burdens from labor to capital owners (Garrett and Mitchell, 2001).

On the other hand, the efficiency hypothesis states that global market integration compels governments to opt for more market-oriented policies to remain competitive in international markets (Cerny, 1995; Swank, 2006). Due to growing international competition, governments are under pressure to improve domestic firms' competitiveness in

international markets and thus reduce social spending programs to cut labor costs (Rudra, 2002; Swank, 1998) or transfer tax burdens from capital to labor or consumers (Wibbels and Ahlquist, 2011). Trade openness and capital mobility combined with heightened exit threats by multinational corporations and investors may constrain governments' efforts of social welfare spending, particularly if high labor costs are the main driver of offshore outsourcing. Under this pressure, governments may lose tax autonomy and cut tax rates especially on mobile factors such as capital (Leibrecht and Hochgatterer, 2012), which can lead to a race to the bottom in taxation (Bretschger and Hettich, 2002; Genschel, 2002) [1].

To test the arguments, scholars have examined competition-related factors such as the level of import or trade openness (Hays *et al.*, 2005), economic crises (Lammers *et al.*, 2018) and types of government spending (Heimberger, 2021), supply-side factors such as regime types, government partisanship and fiscal needs (Avelino *et al.*, 2005; Betz and Pond, 2023; Rudra and Haggard, 2005), and demand-side factors such as geographical concentration of losers (Menendez, 2016), public preferences (Beesley, 2020; Hellwig, 2014), the power of political left and organized labor (Rudra, 2002; Engler, 2021) and factor mobility (Hwang and Lee, 2014).

Empirical evidence is largely mixed. In fact, despite the clear theoretical distinction between the two hypotheses, governments often employ mixed policy tools that do not serve only one policy end. Notably, the key instrument of efficiency politics, capital tax reduction, has been frequently used along with the key instrument of compensation politics, increased compensation spending. In our sample of country year observations, only 44.5% of governments used spending and taxation policies consistently with either the compensation (19.2%) or the efficiency (25.3%) hypothesis. In 22% of the sample, government employed an expansionary fiscal policy (i.e. increased compensation spending and reduced corporate tax burdens). This observation implies that the efficiency and compensation hypotheses may be complementary in some situations. An interesting question is then under what conditions governments utilize the expansionary fiscal policy.

Government fractionalization and expansionary fiscal policy

An expansionary fiscal policy can arise from diverse contexts. For instance, although governments care about domestic competitiveness in international markets and thus have an incentive to reduce capital tax burdens, they may view increased compensation spending does not necessarily hurt the economy. Since social spending can promote national economic competitiveness in global markets by enhancing labor productivity and skills (Kaufman and Segura-Ubiergo, 2001), even capital owners who rely heavily on high-skilled workers in production may not oppose the expansion of welfare programs (Iversen and Stephens, 2008).

Unless economic openness is carefully managed, the backlash against economic globalization can arise anytime especially when losers of globalization are politically powerful (Scheve and Slaughter, 2004; Engler, 2021). Thus, even though increased compensation spending causes financial distress and budget deficit to governments, they are incentivized to promote social welfare spending for the sake of a long-term open economic policy. This view is consistent with the political-economy argument that social programs are functional to the long-term success of the capitalist system, even if these programs place short-term costs and burdens on private businessmen (Berkowitz and McQuaid, 1992). In this regard, Meinhard and Potrafke (2012) claim that, although globalization can cause a reduction in tax revenues, it does not necessarily end up with a welfare state retrenchment. This is because compensation spending may nonetheless rise due to the higher demand for social insurance.

In addition, increased compensation spending does not necessarily require governments to raise burdens on capital and business owners (Genschel, 2002; Swank, 1998). Thanks to

high economic growth and increased overall revenues, governments may be able to raise enough funds to support increased compensation spending without driving up tax rates and burden on business and capital owners. For example, although the share of tax revenues out of GDP increased by approximately 8% from 1970 to 1998 in 16 OECD countries on average, social security contributions rather than corporate taxes were the main driver of the increase (Genschel, 2002). Swank (1998) similarly reports that business tax burden was relatively stable in OECD countries during the period. Relatedly, governments may finance increased compensation expenditures by cutting spending on other items such as public investment instead of raising capital tax burdens (Genschel, 2002).

To account for the adoption of an expansionary fiscal policy, this study focuses on government fractionalization, which is conceptualized as the degree of division of a government. This concept, often measured by the number and size of parties in a government, is strongly associated with "the support that governments enjoy in the legislature and among voters" (Grilli *et al.*, 1991, p. 350). For two main reasons, we argue that highly fractionalized governments (characterized as coalition, minority or fragmented governments) are more likely to support the expansionary fiscal policy than marginally fractionalized governments. First, we find the reason in the "diverse interests" of fractionalized governments. Unlike in governments with strong domestic political support and concentrated power, fractionalized governments require large minimum winning coalitions that include multiple political agents, such as political parties or veto players, in the fiscal policy decision-making process. Since members of the coalitions try to benefit their own constituencies, they are likely to engage in intense political conflict among themselves. Therefore, it is difficult for fractionalized governments to change the status quo or enact controversial policies (Grilli *et al.*, 1991). The diverse interests may put fractionalized governments in the 'war of attrition,' making it difficult to enforce a fiscal policy consistent with either the compensation or the efficiency hypothesis (Alesina and Drazen, 1991). Members in fractionalized governments, though agreed upon the overall direction of fiscal policies, attempt to shift the costs of adjustments (the costs their constituents pay due to compensation spending cuts or capital tax increases) to other parties or agents. The higher the costs are, the longer the fight. Until "one group concedes and bears a disproportionate share of the burden," therefore, agreements about unpopular fiscal policies tend to be delayed (Alesina and Drazen, 1991, p. 1170).

Instead, fractionalized governments pursue popular policies that satisfy coalition members broadly, which may lead to increased government expenditures and tax cuts (Perotti and Kontopoulos, 2002). As Li and Smith (2002) imply, in the era of economic globalization, fractionalized governments are likely to be under high pressure to meet diverse economic interests from multiple coalition members and their constituencies that potentially include both winners and losers of globalization. At the same time, unpopular policy proposals like a decrease in compensation spending or an increase in capital tax burdens can be vetoed easily in fractionalized governments (Roubini and Sachs, 1989) [2].

Broadly, this argument is in accord with the previous literature on the weak government thesis (Perotti and Kontopoulos, 2002; Roubini and Sachs, 1989). Weak governments invite multiple agents and veto-players in the decision-making process of fiscal policy. The larger the number of agents is, the higher the chance of disagreement among agents (Tsebelis, 1995), and thus the harder to maintain a fiscal policy consistent with either the compensation or the efficiency hypothesis. Therefore, fractionalized weak governments are likely to face budget deficits and debt growth (Ashworth *et al.*, 2005; Perotti and Kontopoulos, 2002). For similar reasons, Haggard and Kaufman (1995) argue that weak governments respond poorly to economic crises and often fail to initiate economic reforms.

Second, government fractionalization can induce collective myopia. Disagreements among different political actors in highly fractionalized governments drive policymakers to

weigh the future less but behave more myopically (Grilli *et al.*, 1991). Due to the inability to secure agreements among coalition members within a government (Roubini and Sachs, 1989) and frequent power alternation between competing political actors, fractionalized governments have incentives to pursue short-sighted policies, focusing on immediate benefits rather than long-term future effects. In this regard, the expansionary fiscal policy may be a rational strategy for myopic policymakers in fractionalized governments expecting next elections. Scholars in political economy point out the 'fiscal illusion' that voters may have. Since voters are not well informed of intertemporal budgetary constraints of the government, they tend to overestimate the benefits of current spending and underestimate the future tax burden (Buchanan and Wagner, 1977; Shi and Svensson, 2006). Accordingly, voters under fiscal illusion favor policymakers who offer an expansionary fiscal policy. As demand for compensation for losses or assistance for competition arises as consequences of globalization, highly fractionalized governments are likely to discount the future in favor of short-sighted expansionary fiscal policies for electoral reasons.

This idea is also related to the political business cycle literature that posits that voters reward politicians who support expansionary budgetary policies in election years (Alesina *et al.*, 1992). We do not claim that expansionary budgetary policies entirely result from opportunistic behavior of policymakers before elections [3]. Under right circumstances, however, the possibility that fractionalized governments seek an expansionary fiscal policy can be high. Eslava (2011, p. 647) argues that, concerning the occurrence of fiscal deficits driven by opportunistic behavior, policymakers are "interested in garnering votes for themselves or their parties" with changing economic policy and voters are "assumed to value public spending" and its benefits. Rogoff (1990) also contends that an expansionary fiscal policy can be a rational election strategy. Having limited information about politicians' competence levels, voters may give weight to expansionary fiscal policies in their competence assessment. If this is the case, politicians in fractionalized governments may be strongly in favor of an expansionary fiscal policy.

Relatedly, the argument is associated with the literature on the time inconsistent policy preferences (Alesina and Tabellini, 1990). Due to high uncertainty about one's prospect to be in power after future elections, current governments may act strategically to limit the choice set of future governments and thus increase indebtedness. For instance, Persson and Svensson (1989) show that conservative governments, despite their preferences of reduced government spending and corporate taxes, have an incentive to run a deficit to constrain the choices of the liberal successors especially when governments are weak and thus expect to lose future elections [4]. Finally, based on these arguments, the study presents the following hypothesis:

H1. Ceteris paribus, as a response to globalization, highly fractionalized governments are more likely to utilize an expansionary fiscal policy that involves an increase in compensation spending and a decrease in capital tax burdens than marginally fractionalized governments.

Research design

We test our hypothesis with a country-year data covering 24 OECD countries from 1980 to 2011. To examine how a single country juggles compensation spending and capital taxation policies jointly, we employ a research strategy that classifies governments into four categories based on their implementation of the two policies. The first group is 'the efficiency-promoter" (25.3% in our sample). They are the governments that use the policies in accordance with the efficiency hypothesis: decreases in both compensation spending and capital tax burdens [5]. The second group of governments is 'the compensator" (19.2%).

They are the governments that use the policies in accordance with the compensation hypothesis: increases in both compensation spending and (at least no decreases in) capital tax burdens. The third group is 'the expansionary" (22.2%). They increase compensation spending but decrease capital tax burdens. Examples include Switzerland in 2002 and 2003. In these years, Switzerland's economy was struggling, and its unemployment rate increased from 1.9% in 2000 to 3.7% in 2003. Government compensation spending increased from 4.87% in 2001 to 5.97% of its GDP in 2003. Capital tax burden decreased from 22% in 2001 to 20.3% of its total government taxation in 2003. The total vote share of the government parties then was 58.2%, which was lowest in Switzerland during the analysis period [6]. Finally, the last group is 'the contractionary" (33.3%): they decrease compensation spending but increase (at least does not reduce) capital tax burdens. This tight or contractionary fiscal policy can be designed to restrain the economy particularly during or in anticipation of an inflation-inducing business-cycle expansion. This type of fiscal policy is often observed when a country is in a financial crisis, economic recession or recovery. Examples include several Asian economies such as South Korea or Indonesia right after 1997 financial crisis.

Variables and data

By taking first differences in compensation spending and capital taxation burdens, we identify each country-year observation based on the four categories. The dependent variable, *Government Response*, has four values: 0 (the contractionary), 1 (the efficiency-promoter), 2 (the compensator) and 3 (the expansionary). To examine the difference between the expansionary and the other types of fiscal policies, we also create a binary dependent variable, *Government Response II*, which is coded as 1 for the expansionary and 0 for the others. To estimate our models, we use multinomial logit regression for *Government Response* with country fixed effects, and logit regression with country random effects for *Government Response II*.

To measure compensation spending, we use data on welfare spending and industrial subsidies. Welfare spending includes unemployment benefits and active labor market programs (ALMPs) as two main categories [7] Industrial subsidies are direct grants that governments make to enterprises. The sum of these expenditures is measured as % of GDP [8] The data come from the OECD (2023). Alternatively, we measure these expenditures as % of total government spending. This is because they may show government spending priorities better and measure the allocation of resources under the government direct control (Wibbels and Ahlquist, 2011). To measure capital tax burdens, we use data on corporate income taxes and employers' social security contributions for capital taxes (OECD, 2023). The sum of these two items, measured as % of total government taxation, effectively shows financial burdens capital and business owners carry.

The explanatory variables in our analysis are *Globalization* and *Government Fractionalization*. We measure globalization using changes in imports ($\Delta Import$) as a share of GDP between time t-1 and time t. Short-term changes in imports are well connected to heightened economic insecurity and dislocation caused by global competition and thus have significant implications to domestic politics (Cao *et al.*, 2007). To control for the long-term static effects of international competition, we also include the level of imports as % of GDP (*Import_1*) in the models. The data comes from the World Bank (2023).

Government Fractionalization is measured by the total seat share of all non-government parties in parliament. As the seat share of government parties decreases, the government is likely to face stronger opposition from other parties, veto-players and the public over fiscal policy. This measure can appropriately indicate the level of constraints on government power and policy autonomy (Li and Smith, 2002). As an alternative measure, we also use the total

vote share of all non-government parties in parliament [9] The data come from the World Bank's Database of Political Institutions (DPI) (Beck *et al.*, 2001). By creating an interaction term between government fractionalization and import variables, we evaluate whether the effects of import on government fiscal policy response is conditioned on government fractionalization.

There are several political and economic controls in our models. Existing studies find that right- and left-wing parties cater to distinct constituencies by articulating competing policy packages. Broadly defined, governments on the right are expected to cater to capital owners and thus associated with the formation of policies which aim to promote the market, its efficiency and low taxation. Governments on the left, by contrast, are linked to the greater development of state-led compensation programs. *Partisanship* is coded as 3 for left-government, 2 for central- and 1 for right-governments. The number of years the chief executive has been in office, *Years (in office)* and whether the party of the executive has a majority of the houses that have lawmaking powers, *Undivided Gov't,* are associated with both government fractionalization and fiscal policy preferences. We control for these factors using data from DPI. We expect that the longer the chief executive has been in office, the less the government is likely to become the expansionary. Similarly, undivided governments are less likely to become the expansionary than divided governments.

As economic controls, exports, FDI, GDP growth, GDP per capita, inflation, unemployment and external debt size are included. It is generally expected that good economic conditions reduce the necessity of employing an expansionary fiscal policy. For example, export increases are likely to minimize disruptions caused by increased imports and thus reduce the demand for compensation. High GDP growth and GDP per capita are also believed to reduce backlash against import competition. While governments carrying a huge amount of debt are not likely to implement an expansionary fiscal policy, high unemployment rates could be a driving factor of such fiscal policy. As these economic conditions become positive, we expect that governments are less likely to employ an expansionary fiscal policy. By using first-differenced values, we capture the dynamic aspects of these economic variables. The data on economic controls come from the World Bank (2023). For descriptive statistics, refer to Table 4 in online appendices.

Results

To test the hypothesis, we first examined the differences between the expansionary and the other types of governments. The results in Table 1 show that as the size of import increases, a highly fractionalized government is likely to utilize increased compensation spending and decreased capital taxation policies. However, when the government is marginally fractionalized, import has a negative impact on the probability of choosing the expansionary fiscal policy, which supports our claim.

Figure 1 generated from Model 1.1 visually clarifies the conditional effects of government fractionalization on the relationship between import and the expansionary fiscal policy. The results remain consistent when we measure compensation spending as a percentage of total government spending in Model 1.2.

As another way to test the hypothesis, we examined the differences among four types of governments. As Table 2 shows, import and its interaction term with government fractionalization have significant effects on the fiscal policy choices. When governments are highly fractionalized, as the size of import increases, they are likely to utilize the expansionary rather than the contractionary or efficiency-promoting fiscal policy. Meanwhile, the conditional effect of government fractionalization on the difference between the expansionary and the compensatory fiscal policies is relatively weak as shown in Model 2.3. This implies that when governments are highly fractionalized, they tend to increase

DV	Model 1.1 The Expansionary	Model 1.2 The Expansionary
ImportFD	−0.881*	−0.997**
	(0.368)	(0.368)
*ImportFD*Gov.Frac*	0.019*	0.021**
	(0.008)	(0.008)
Gov.Frac	−0.003	0.004
	(0.012)	(0.012)
Partisanship	−0.063	0.143
	(0.227)	(0.218)
Years (in office)	−0.033	−0.028
	(0.043)	(0.041)
Undivided Gov't	−0.204	−0.123
	(0.275)	(0.261)
UnemploymentFD	0.531**	0.569**
	(0.143)	(0.146)
InflationFD	0.101*	0.115*
	(0.047)	(0.047)
Import_1	−0.008	−0.010
	(0.008)	(0.008)
ExportFD	−0.167*	−0.095
	(0.072)	(0.077)
FDIFD	−0.002	−0.014
	(0.024)	(0.023)
LnGDPPCFD	10.32	2.99
	(6.54)	(6.42)
Growth_1	−0.051	−0.107*
	(0.057)	(0.054)
DebtFD	−0.008	−0.012
	(0.009)	(0.009)
Constant	−0.225	−0.495
	(0.678)	(0.676)
N	546	527
χ^2	53.14**	48.26**
Number of Countries	24	24

Note(s): Logit estimates of *the Expansionary*. Compensation spending is measured as a percentage of the GDP in Model 1.1 and as a percentage of total government spending in Model 1.2. Country-random effects. *p*-values: $^{**}p < 0.01$, $^{*}p < 0.05$. Two-tailed tests
Source(s): Table by authors

Table 1. Government fractionalization and expansionary fiscal policy (OECD, 1980–2011)

compensatory spending, but their preferences over capital taxation are uncertain. The substantive results remain virtually the same when we use the total vote share of all government parties in parliament as reported in Table 5 in Appendices [10].

When we measure compensation spending as % of total government spending, the results, as reported in Table 3, corroborate our claims that fractionalized governments are likely to implement the expansionary fiscal policy rather than contractionary, efficiency-promoting or compensatory fiscal policy.

To evaluate substantive effects of import, government fractionalization and their interaction on fiscal policy choices, we create two figures of predicted probabilities using Models 2.1 and 3.1. To this end, we used *Clarify* simulation program (Tomz *et al.*, 2001).

As the figures show, when governments are highly fractionalized (e.g. government parties have 25–40% of the seat share) and the import level is relatively high, the probabilities that

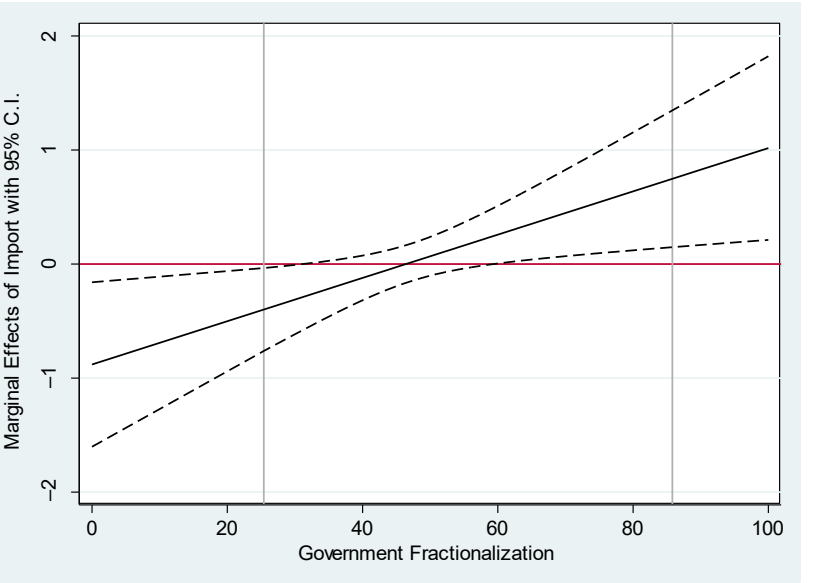


Figure 1.
Marginal Effects of Import on Expansionary Fiscal Policy conditioned on Government Fractionalization

Note(s): Based onModel 1.1. All other variables are fixed at their means or modes. Dash lines indicate 95% confidence intervals (CIs). Reference linesin government strength indicate the actual range in the data
Source(s): Figure by authors

governments use the expansionary fiscal policy are high (27–34% in Figure 2 and 34–48% in Figure 3). As the level of government fractionalization decreases (e.g. government parties have 60–85% of the seat share), however, the probability of using the expansionary fiscal policy decreases (9–18% in Figure 2 and 7–20% in Figure 3). Overall, these findings strongly support our hypothesis and show that the effects of import on the expansionary fiscal policy is conditioned on government fractionalization.

The results in Tables 2 and 3 also show that governments are likely to take the expansionary fiscal policy when unemployment rate is high but unlikely to do so when export or growth rate is high, which is consistent with our expectation. Similar results are found in Table 1. Other control variables, in general, do not have statistically significant effects on the choice of expansionary fiscal policy over other types of fiscal policy options. For example, government partisanship, whether it is a left or right-wing government, the number of years the chief executive has been in office, or changes in the debt size do not explain the choice of fiscal policy significantly, potentially implying that governments' fiscal policy response to economic globalization are a complex decision that cannot be easily explained by their political orientation or budget conditions.

Conclusion

Various economic or political factors may account for governments' diverse fiscal policy responses to globalization, thereby producing mixed empirical evidence that supports the compensation or the efficiency hypothesis. By examining government fractionalization as

Reference	Model 2.1 Contractionary	Model 2.2 Efficiency-promoter	Model 2.3 Compensator
	The Expansionary	*The Expansionary*	*The Expansionary*
ImportFD	−1.140**(0.398)	−0.809* (0.395)	−0.714 (0.392)
*ImportFD*Gov.Frac*	0.025**(0.008)	0.017* (0.008)	0.013 (0.008)
Gov.Frac	−0.024 (0.021)	0.000 (0.021)	−0.039 (0.021)
Partisanship	−0.204 (0.314)	−0.207 (0.334)	−0.146 (0.356)
Years (in office)	−0.013 (0.060)	−0.067 (0.061)	−0.049 (0.062)
Undivided Gov't	−0.877* (0.435)	0.507 (0.455)	−0.590 (0.434)
UnemploymentFD	0.606**(0.209)	0.392 (0.203)	0.083 (0.206)
InflationFD	0.104 (0.061)	0.016 (0.108)	0.213**(0.069)
Import_1	−0.034 (0.032)	−0.076 (0.048)	−0.048 (0.033)
ExportFD	−0.288**(0.100)	−0.134 (0.103)	−0.105 (0.083)
FDIFD	−0.018 (0.021)	0.006 (0.026)	−0.003 (0.022)
LnGDPPCFD	−32.54**(12.49)	−34.12 (10.36)	0.185 (9.31)
Growth_1	−0.185* (0.089)	0.01 (0.079)	−0.167* (0.084)
DebtFD	−0.005 (0.011)	−0.007 (0.010)	0.001 (0.011)
	The Compensator	*The Contractionary*	*The Efficiency-promoter*
ImportFD	−0.426 (0.328)	0.330 (0.336)	0.096 (0.325)
*ImportFD*Gov.Frac*	0.012 (0.006)	−0.009 (0.007)	−0.003 (0.006)
Gov.Frac	0.015 (0.021)	0.024 (0.019)	−0.039 (0.021)
Partisanship	−0.057 (0.337)	−0.003 (0.290)	0.061 (0.361)
Years (in office)	0.036 (0.059)	−0.055 (0.055)	0.018 (0.061)
Undivided Gov't	−0.287 (0.469)	1.384**(0.452)	−1.097*(0.485)
UnemploymentFD	0.523* (0.215)	−0.214 (0.174)	−0.309 (0.211)
InflationFD	−0.109 (0.065)	−0.089 (0.054)	0.197**(0.067)
Import_1	0.014 (0.030)	0.012 (0.027)	−0.027 (0.029)
ExportFD	−0.183* (0.089)	0.154 (0.092)	0.029 (0.096)
FDIFD	−0.016 (0.019)	0.025 (0.030)	−0.009 (0.026)
LnGDPPCFD	−32.73* (13.01)	−1.58 (10.47)	34.31**(10.77)
Growth_1	−0.018 (0.083)	0.186**(0.069)	−0.168*(0.075)
DebtFD	−0.006 (0.010)	−0.002 (0.009)	0.008 (0.008)
N	546	546	546
χ^2	185.15**	185.15**	185.15**

Note(s): Multinomial logit estimates with four categories. Compensation spending as % of the GDP. Country fixed effects. Robust standard errors. *p*-values: $^{**}p < 0.01$, $^{*}p < 0.05$. Two-tailed tests
Source(s): Table by authors

Table 2. Government fractionalization and fiscal policy response to globalization (1980–2011)

one of the critical factors that constrain the fiscal policy choice, this study enhances our understanding of the relationship between economic globalization and compensation or efficiency policies. In comparison with marginally fractionalized governments, highly fractionalized governments need to satisfy broad audience, invite more agents and veto-players in decision-making processes, look forward to short-term political gains rather than long-term plans for the economy and thus tend to maintain an expansionary fiscal policy. The arguments and findings in this study explain why governments utilize the seeming incompatible policy preferences over increased compensation spending and reduced capital tax burdens as a response to globalization, potentially subsuming both hypotheses.

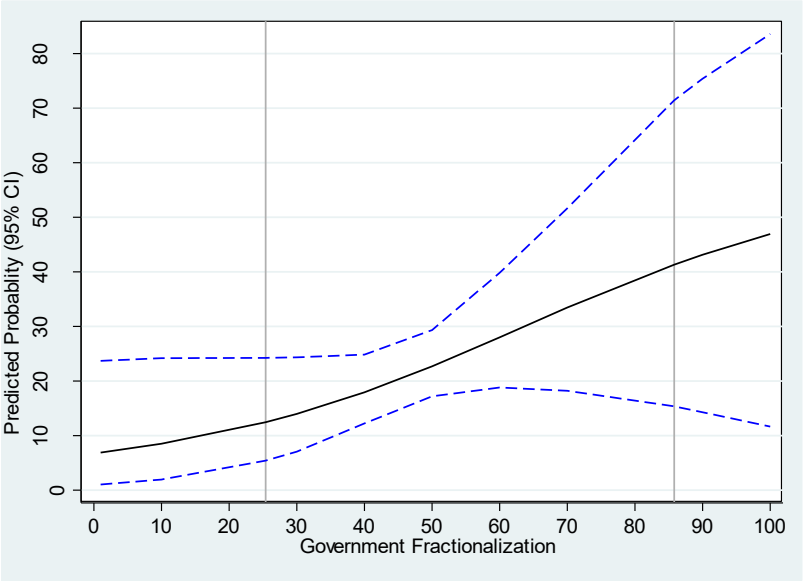
In recent decades, we have observed frequent occurrence of debt crises in many countries. For example, in 2009, several countries in the EU system such as Ireland and Spain experienced increases in debt. Global public debt-to-GDP ratio tripled from the mid-

Reference	Model 3.1 Contractionary	Model 3.2 Efficiency-promoter	Model 3.3 Compensator
	The Expansionary	*The Expansionary*	*The Expansionary*
ImportFD	−1.284**(0.442)	−1.167**(0.426)	−1.015* (0.418)
*ImportFD*Gov.Frac*	0.027**(0.009)	0.024**(0.009)	0.019* (0.009)
Gov.Frac	−0.001 (0.022)	0.037 (0.023)	−0.022 (0.021)
Partisanship	0.198 (0.331)	0.297 (0.347)	−0.145 (0.325)
Years (in office)	−0.030 (0.059)	−0.105 (0.062)	−0.039 (0.055)
Undivided Gov't	−0.415 (0.452)	0.942* (0.461)	−0.792 (0.436)
UnemploymentFD	0.535* (0.218)	0.476* (0.233)	0.305 (0.181)
InflationFD	0.154* (0.061)	0.056 (0.045)	0.225**(0.065)
Import_1	−0.092**(0.033)	−0.100**(0.032)	−0.075* (0.033)
ExportFD	−0.172 (0.103)	−0.068 (0.111)	−0.073 (0.096)
FDIFD	−0.034 (0.025)	−0.014 (0.030)	−0.016 (0.026)
LnGDPPCFD	−13.50 (11.47)	−11.63 (10.16)	6.10 (8.54)
Growth_1	−0.248**(0.094)	−0.042 (0.076)	−0.183* (0.075)
DebtFD	−0.010 (0.010)	−0.008 (0.009)	0.003 (0.009)
	The Compensator	*The Contractionary*	*The Efficiency-promoter*
ImportFD	−0.269 (0.320)	0.117 (0.353)	0.152 (0.321)
*ImportFD*Gov.Frac*	0.008 (0.007)	−0.004 (0.007)	−0.005 (0.006)
Gov.Frac	0.020 (0.021)	0.038 (0.022)	−0.059**(0.023)
Partisanship	0.343 (0.327)	0.099 (0.322)	−0.442 (0.354)
Years (in office)	0.008 (0.058)	−0.075 (0.062)	0.066 (0.061)
Undivided Gov't	0.377 (0.480)	1.357**(0.477)	−1.734**(0.490)
UnemploymentFD	0.230 (0.214)	−0.059 (0.198)	−0.171 (0.227)
InflationFD	−0.071 (0.059)	−0.098 (0.058)	0.169**(0.063)
Import_1	−0.017 (0.030)	−0.008 (0.029)	0.024 (0.030)
ExportFD	−0.099 (0.092)	0.104 (0.111)	−0.005 (0.104)
FDIFD	−0.018 (0.019)	0.021 (0.030)	−0.003 (0.030)
LnGDPPCFD	−19.60 (11.40)	1.87 (11.37)	17.73 (9.88)
Growth_1	−0.065 (0.088)	0.205* (0.082)	−0.140 (0.071)
DebtFD	−0.013 (0.010)	0.002 (0.010)	0.011 (0.009)
N	527	527	527
χ^2	5480.48**	5487.28**	5499.78**

Table 3. Government fractionalization and fiscal policy response to globalization (1980–2011)

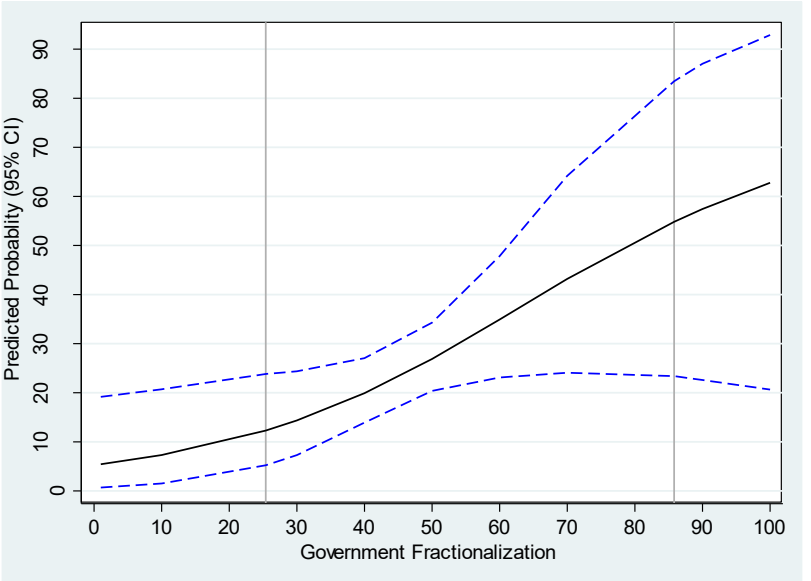
Note(s): Multinomial logit estimates with four categories. Compensation spending as % of total government spending. Country-fixed effects. Robust standard errors. *p*-values: $^{**}p < 0.01$, $^{*}p < 0.05$. Two-tailed tests
Source(s): Table by authors

1970s to 92% by 2022 (Gaspar *et al.*, 2023). Since this is a rather systemic trend observed in many places worldwide, governments' fiscal policy responses to globalization may be strongly relevant to debt crises. When governments increase compensation spending but reduce capital tax burdens for a long time, increased deficits can push up public debt-to-GDP ratios. Our findings suggest that fractionalized governments are likely to face budget deficits and debt crises, as the expansionary fiscal policy persists over time. In this regard, future studies will benefit by exploring the connection between the expansionary fiscal policy and debt crises across governments with different levels of government fractionalization. Relatedly, future studies will also benefit by exploring how domestic pressure from different societal groups such as labor or capital owners interacts with government fractionalization in explaining the employment of various compensation and capital taxation policies.



Note(s): Based onModel 2.1. All other variables are fixed at their means or modes except Δ*Import* (75 percentile value). *Clarify* simulation program (Tomz *et al*., 2001) is used. Reference lines indicate the actual range in the data
Source(s): Figure by authors

Figure 2.
Predicted probability of expansionary fiscal policy (with 95% CIs)



Note(s): The figure is created using Model 3.1. All other variables are fixed at their means or modes except Δ*Import* (75 percentile value). Reference lines in government fractionalizationindicate the actual range in the data
Source(s): Figure by authors

Figure 3.
Predicted probability of expansionary fiscal policy (with 95% CIs)

Notes

1. However, empirical results largely reject the argument, and scholars disagree on the extent to which tax reforms can be attributed to globalization. For example, Plumper *et al.* (2009) explain that, under budget rigidities and fairness norms, governments cannot fully abolish taxes on mobile capital.
2. It is also possible that reduced clarity of responsibility in fractionalized governments may discourage multiple veto players to alter the status quo and implement an expansionary fiscal policy (Powell and Whitten, 1993). However, when demands for protection or support rise from their key constituencies, it is difficult for decision-makers in fractionalized governments not to take actions to protect their constituencies' interests, which may induce reckless spending and taxing policies (Grille *et al.*, 1991).
3. Refer to Eslava (2011) for the summary of the criticism against the fiscal illusion.
4. However, this explanation is applicable mainly to the time period close before/after elections.
5. One example is the Canadian government in 1987 and 1988. Thanks to Prime Minister Mulroney's pro-business plan of tax cuts, capital tax burden as the share of total government taxation decreased from 17.14% in 1986 to 16.63% in 1988, while compensation spending as the share of GDP decreased from 4.61% in 1986 to 3.77% in 1988. The seat share of government parties in parliament was 74.82%. Another example is Ireland. Since 1987, the government had implemented efficiency-promoting policies.
6. However, during the recession period of 1991–1993, the government became a compensator. Its compensation spending increased from 3.9% in 1990 to 5.86% in 1993. Capital tax burdens increased from 17.82% in 1990 to 18.96% in 1993. The total vote share of government parties was 70.2%. Another example of the expansionary is Finland in 1992–93. Due to severe recession and high unemployment rate (10–18%), compensation spending increased but capital tax burdens decreased. The government parties' seat share was relatively low, 53.7%. Despite high unemployment rates, the government utilized a contractionary fiscal policy in 1997–2000 when the seat share increased to 72.64%.
7. They are two key items of welfare spending, which are very closely associated with governments' efforts to support workers facing hardships caused by globalization (Cao *et al.*, 2007).
8. As previous studies argue (Cao *et al.*, 2007; Hwang and Lee, 2014), welfare spending and industrial subsidies are two key tools of compensation politics.
9. In addition, similar to Roubini and Sachs (1989), we construct an index of government fractionalization. This variable takes on 7 for minority coalition government, 6 for minority government, 5 for a coalition with three or more parties, 4 for a two-party coalition, 3 for a coalition with single majority and two or more other parties, 2 for a two-party coalition with single majority party, 1 for one-party government with not more than 70% of seats and 0 for one-party government with more than 70% of seats in parliament.
10. When we use an index of government fractionalization (Roubini and Sachs, 1989), the substantive results remain consistent: single-party governments are less likely to employ the expansionary fiscal policy than minority or coalition governments. The results are reported in Table 6 in Appendices.

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Online appendices

The supplementary material for this article can be found online.

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