

Can Globalization Cause the Fiscal Crisis?

- An Empirical Investigation of the Compensation Hypothesis -

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Abstract

Among a number of studies on the effect of globalization on nation states and their domestic policies, the 'compensation hypothesis' posits a positive relationship between openness to world market and the size of government, thereby providing a link between globalization and fiscal crisis. It is based on the argument that the government tends to compensate people for their additional risks due to globalization such as rising inequality, but the empirical results of the existing literature are inconclusive. This paper investigates the validity of the 'compensation hypothesis' in a new empirical setting. It is found that economic globalization and trade openness variables have a positive and statistically significant effect on the debt-to-GDP ratio among the OECD countries, while social and political globalization variables show no significant effect. The results suggest that economic impact of globalization could have a profound impact on the fiscal soundness of a country, which may result in a fiscal crisis in the future.

Key words: compensation hypothesis, fiscal crisis, globalization

1. Introduction

The impact of globalization on national economy has been a popular research topic among many scholars. Increasing international trade and borderless nature of global capital are key hallmarks of contemporary globalization. Various possible effects of increasing and intensifying international trade and finance on domestic society have been a thorny issue in many societies that

cannot be underestimated. For example, it is widely accepted that economic crises in 1997 and 2008 have affected the economy and society of many countries, especially in South Korea, in an unprecedented way and their effects are still ongoing. Our history shows that there could be a grave risk from globalization and can make our society vulnerable to outside force. With those experiences, globalization came to many people as a threat rather than an opportunity.

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There exist many academic discussions on the effect of globalization. Increasing international goods and service trade, facilitated by unprecedented development of technology, provided a valuable means of developing the economy and society in many countries. However, one line of research has been focusing on a possibly detrimental effect of globalization. The so-called 'Compensation Hypothesis' and related analyses try to explain possible effects of external risk posed by globalization on the size of government, thereby providing a clue to the role of globalization on fiscal crisis.

According to the compensation hypothesis, societies demand an expanded government to compensate for the external risk posed by globalization. The 'compensation' usually can be performed by increasing social expenditure or government spending in various areas to protect people from external risk. In this case, we can also say that government spending plays a role as a type of social insurance. Indeed, public finance is a main instrument for sustaining a social contract in many countries. Therefore, the compensation hypothesis argues that there is a positive relationship between levels of globalization and volume of government expenditure. In other words, compensation hypothesis posits that globalization is highly related to a 'fiscal squeeze' in many countries.

However, past studies on the compensation hypothesis produced inconclusive empirical results, and the validity of the hypothesis has yet to be confirmed. In light of the above circumstance, this paper tries to empirically investigate the validity of the compensation hypothesis, thereby shedding a light on the investigation of the nature of

globalization and its effect on national economy and possible fiscal crisis. This study conducted the empirical analysis with the sample of the OECD countries. Since South Korea became the member-state of the OECD in 1996, fiscal soundness has become a thorny issue in Korean society.

By analyzing cases of the OECD countries, this paper aims to provide a valuable perspective on how to manage fiscal problems of South Korea in facing globalization. In addition, this paper uses a new variable to measure the level of globalization, Openness, which is the ratio of the sum of import and export to the Gross Domestic Product (GDP), has been widely used in many previous analyses to proxy a country's exposure to international trade or globalization. In addition to the traditional openness variable, this paper uses the KOF globalization index which measures not only economic but also social and political aspects of globalization. Recent trends in globalization studies stresses the multi-dimensionality of globalization including cultural, institutional, and political (Robertson & White, 2003; Meyer, 2007). By using this variable in our study, we are expected to comprehend a different nature of globalization and its effect on the fiscal situation in different countries.

This paper proceeds as follows. Chapter 2 examines and discusses the theories on the relationship between globalization and the fiscal situation as well as the results of previous studies on this topic. Chapter 3 provides the research framework and empirical analysis. Chapter 4 concludes the paper.

II. Theoretical Perspectives & Previous Works

1. Effect of Globalization and the Compensation Hypothesis

There are many contending definitions of globalization and most of them are fairly abstract. A definition of globalization that came from some common features among those different definitions states that globalization is an interdependent and multidimensional social process among countries in the world (Held, *et. al.*, 1999; Martell, 2010). The compensation hypothesis is one of the attempts on the investigation of effect of globalization on society. As noted previously, the compensation hypothesis argues that there would be a positive relationship between the levels of globalization and the size of government expenditure. Scholarly discussions concerning the compensation hypothesis are mainly about globalization and its effect, but they have a broader implication on the relationship between markets and governments.

As stated before, the power of borderless global capital played an important role in economic crises that hit many developing countries, including South Korea. In addition, many countries experienced increasing income inequality after opening up to world market (Green, *et. al.*, 2001; Attanasio, *et. al.*, 2004), which brings up the issue of increasing the role of government against the perils of globalization. Based on the discussion, we cannot argue against the fact that globalization came as a threat to society in some countries. However, it is also widely believed that international trade is one of the important factors facilitating economic growth (Pack, 1994; Ben-David & Loewy, 1998;

Frankel & Romer, 1999). South Korea benefited from an export-driven economic development plan, which eventually greatly enhanced the quality of life of its citizens.

Considering this information, globalization seems to have a double-faced feature including other aspects besides economic one. The potential effectiveness that comes from trade cannot be said to preclude the increase in compensation as a social insurance. The benefit of effectiveness is not distributed evenly among people. Facing the force of globalization, there could be more need to protect parts of society that are marginalized by the very effectiveness that came from international trade. Therefore, we have a question to answer. Is globalization to be regarded as 'external risk' that has to be regulated and compensated? Or is it to be regarded as an opportunity to increase effectiveness of the economy and improve people's lives? If empirical evidence supports the second argument, there would be a robust positive relationship between the levels of globalization and the size of government. If countries are forced to expand their role of government by increasing government expenditure, it could also be a possible source of fiscal crisis.

2. Previous Studies on the Compensation Hypothesis

There are many studies that investigated the aforementioned relationship. In one of the pioneering studies on the compensation hypothesis, Cameron (1978) argues that the degree of exposure of the national economy to world markets is one of the reasons for a large public economy in some countries. Specifically, Cameron (1978) singles out a country's

openness in 1960 as the best predictor of tax revenue in 18 OECD countries. In addition, Katzenstein (1985) shows that some small European countries participated in the international economy armed with a domestic compensation strategy, which means a bigger government.

Twenty years after the work of Cameron, Rodrik (1998) provides the first comprehensive empirical analysis on the compensation hypothesis with cross-sectional regression analysis. Rodrik (1998) supports a positive relationship between an economy's exposure to international trade and the size of its government by arguing that government spending would reduce the risk posed by international trade, which emphasizes government's stabilizing role.

After the seminal work of Rodrik (1998), there have been many attempts to prove the validity of the compensation hypothesis. The usual proxy for globalization in these studies is the sum of imports and exports as a percent of GDP (openness). However, these studies also have produced many contrasting results. Lewis-Beck & Rice (1985) found that government size in the United States seems to have expanded in response to increasing foreign trade. Alesina & Wacziarg (1998) argue that larger countries can afford to have a smaller government because market size increases productivity of the market, and it will reduce their need to be open to trade. This idea suggests a positive relationship between openness and government size. In addition, Ram (2009) found a statistically significant relationship between openness and government size.

Contrary to the previous studies, there are some studies providing rather ambiguous results. Focusing

on non-budgetary measures rather than expenditure, Garen & Trask (2005) shows that the scope of government is much larger in less-open economies. Benarroch & Pandey's (2012) also does not support a causal relationship between openness and government expenditure. Rather than analyzing the entire set of countries, the above two studies tried to divide their sample countries into multiple sets in the hope of finding differences among groups.

Some studies provide possible explanations of inconclusive empirical results on the compensation hypothesis. Garen & Trask (2005) argue that more openness means smaller government because both indicate less intervention of government in the economy. They also argue that open economies could have smaller governments because government intervention is less effective in more open economies. Rodrik (1998) states that most types of government intervention have an adverse effect on the operations of markets and expanding international markets could undermine the effectiveness of government action.

In all, previous analyses do not provide us a coherent conclusion on the compensation hypothesis and potential effect of globalization on a country's fiscal soundness is yet to be proven.

III. Empirical Analysis

1. Basic Setting and Data

The framework of the empirical analysis employed in this paper is fairly straightforward. A country-level panel regression analysis spanning 14 years (2000 to 2013) is performed with the dependent variable of general government debt-

to-GDP ratio and the main independent variable of levels of globalization. Other control variables, which are further explained, are also included in the model.

The following model is our basic specification in this study. In addition to Debt (dependent variable) and Globalization (main independent variable), X denotes the set of other control variables. The model has a panel structure with different units and time periods.

$$Debt = \alpha_0 + \beta_k Globalization + \sum \gamma_j X_{jit} + \epsilon \quad (1)$$

As a proxy for fiscal soundness in OECD countries, general government debt-to-GDP ratio is used as the dependent variable that we want to explain with the levels of globalization. General government debt-to-GDP ratio is an indicator of a country's fiscal health and an important factor for the sustainability of government finance. The data are easily obtainable at the OECD Stat website. For the main independent variable, as stated above, most previous papers used openness (the sum of export and import divided by GDP) as a proxy for globalization. However, the KOF Index of Globalization (Dreher, *et. al.*, 2008) is used as the main independent variable in this study. As stated previously, there exist other aspects in globalization besides the economic dimension. These other factors can also affect a country's fiscal situation. It is reasonable to argue that political, social, and cultural influence of globalization can influence a country's domestic environment, which in turn can be reflected in fiscal policy. The KOF globalization measure provides us with a means to

examine the above argument.

A more detailed explanation of the KOF globalization index is in order. KOF is the abbreviation of a Swiss research institution that produced the KOF index. The KOF globalization index is an aggregate index measuring the three main dimensions of globalization: economic, social, and political. Each category has sub-factors that are used to produce an aggregated index. KOF economic globalization has two sub-factors, which are actual flows of trade among countries and formal and informal restriction of trade. Actual flows include trade, foreign direct investment, portfolio investment, and income payable to foreign nationals, all measured as percent of GDP. Restriction categories include factors such as tariff rates and taxes on international trade, etc. KOF social globalization include data on personal contact such as share of foreign population and data on information flows, and data on cultural proximity such as per capita number of McDonald's restaurant and IKEA shops. Political globalization include data such as membership in international organizations and treaties.

(Figure 1) describes kernel density estimations of debt and KOF globalization variables in the OECD countries. The Kernel density estimate is a non-parametric way of describing the distribution of a variable, which is easier to understand as a general shape of a variable than histogram or bar graph. In (Figure 1), the highest value in government debt is approximately 50% and we can see some countries have rather high government debt-to-GDP ratio. The KOF globalization index is supposed to have a 0 (min) to 100 (max) points range. The peak is formed at the level that is

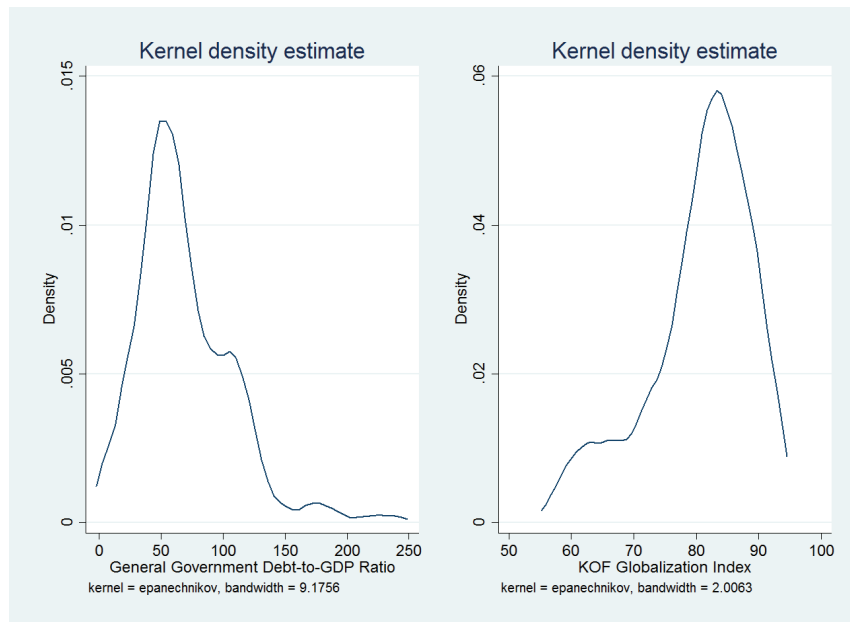


Figure 1. Kernel density estimate of debt and globalization variables

slightly greater than 80 points. Both government debt and KOF globalization show a somewhat similar shape to normal distribution. <Figure 2> shows a dot graph on debt and globalization variables with country names. OECD is considered a group of wealthy nations, but as we can see in <Figure 2>, there is a substantial difference among countries around two variables. In addition, the

comparison of Economic, Social, and Political globalization among the OECD countries is depicted in <Figure 3>. We can see that three aspects of globalization show a substantial variance among the OECD countries, which could lead to the different effect on government debt.

This study includes other control variables that can affect the level of government debt. Control

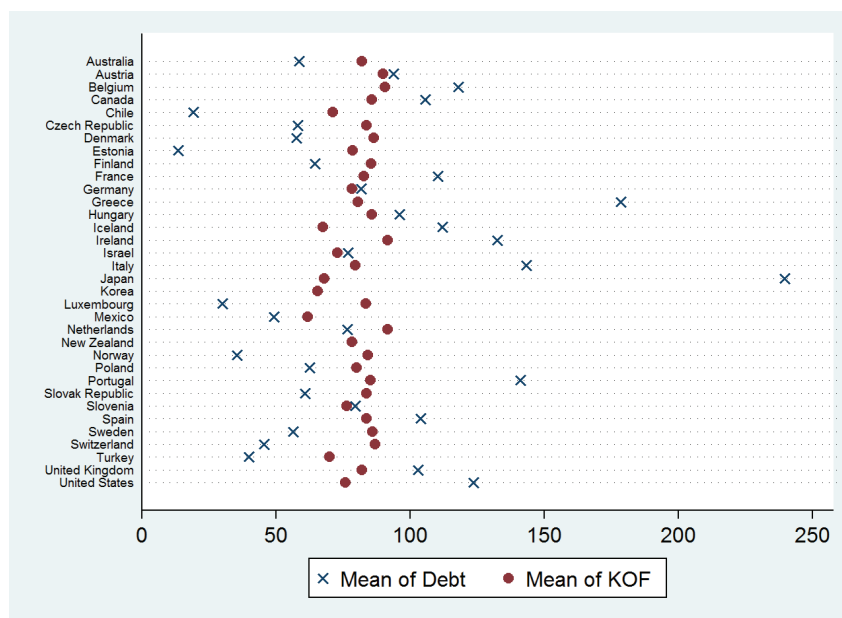


Figure 2. Levels of government debt and globalization in OECD countries

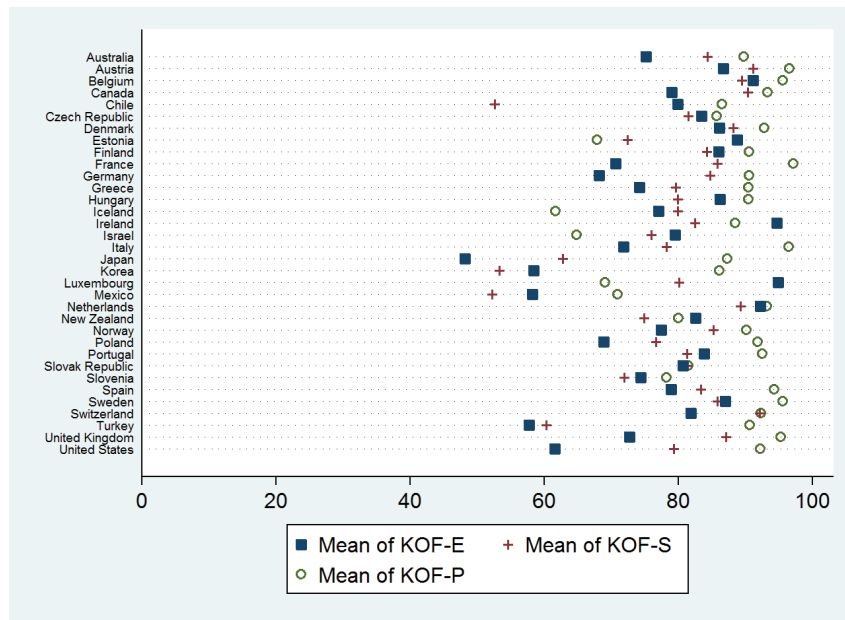


Figure 3. Levels of economic, social, and political globalization in OECD countries

variables are selected if they could have positive or negative effect on government expenditure since excessive government expenditure directly leads to government debt. Annual research and development expenditure and an expenditure for social welfare could directly affect government expenditure level. Unemployment rates could require special service from government for the unemployed, which could aggravate fiscal soundness. Percentage of the population with age of 65 or older is also included in the model. It is expected to be positively correlated with government expenditure and government debt since a higher welfare expenditure is needed for a larger dependent population. In addition, GDP per capita generally reflects how much the economy has matured and total GDP reflects a country's size of the economy. Both variables are expected to influence the level of government expenditure and government debt. Voice and accountability is one of the six governance indicators published by the World Bank (www.govindicators.org). It captures perceptions

of people to the extent that a country's citizens are able to take part in selecting their government, as well as freedom of expression, etc. In addition to economic and demographic factors, the political nature of the budget and spending process could trigger excessive government expenditures. High scores in citizen's voice and government accountability could reflect the above political aspects and affect the level of government debt. Another political variable that is expected to affect fiscal situation, is Political Stability and Absence of Violence, which came from the World Bank. In addition, overall rates of personal income tax on dividend income and corporate income tax are included in the model. For any government, tax is the primary means to collect money. Tax rates can have effects in many ways on government revenues and expenditures. In addition, year dummies are included in all regressions to control for any possible year-specific effects. <Table 1> shows descriptive statistics for variables used in the empirical analysis.

Table 1. Descriptive statistics

Variables	Min	Mean	Max	Std. Dev.
Debt (%)	38,6273	68,8891	239,7519	38,6274
KOF Globalization (point)	57,26	80,4628	92,5	8,3360
KOF Economic Globalization (point)	44,48	77,6028	99,16	11,5722
KOF Social Globalization (point)	49,1	78,7682	93,01	11,1353
KOF Political Globalization (point)	50,06	87,0656	98,42	10,1423
Research and Development (% of GDP)	,3105	1,8256	4,4795	,9910
Unemployment Rate (%)	2,1	7,3748	27,3	3,8605
Old Population (+65; %)	4,6642	14,6030	25,0577	3,6833
Social Welfare Expenditure (% of GDP)	4,821	20,6445	33,021	5,8071
Overall Income Tax Rate (%)	19	43,6481	74	9,9990
Voice and Accountability (point)	−,4289	1,1811	1,8264	,4124
Political Stability & Absence of Violence (point)	−1,6230	,7247	1,6681	,6516

※ Source: OECD Stat.

2. Results of Empirical Analysis

〈Table 2〉 shows the full results of the panel regression analysis. In all models, The Hausman test was conducted to figure out if there is a systematic difference between the fixed-effects model and the random-effects model. The results of the Hausman test showed that the null hypothesis that the random-effects model provides consistent estimates is rejected in every model. Therefore, results from the fixed-effects model are reported in 〈Table 2〉. In addition, to control for heteroskedasticity and autocorrelation, estimators with cluster robust standard errors are used throughout the entire process. In model (1), globalization turns out to have a positive effect on government debt. The result says that a 1-point increase in the globalization index increases general government debt-to-GDP ratio by 1,4656%. Since the globalization index is formed with a 0 to 100 scale, the magnitude of the effect of globalization is not something to be underestimated. It is also statistically significant at 1% level. KOF economic globalization and trade openness are also have a positive and statistically significant (at 5% level and 1% level, respectively) effect on government debt. However, political and social globalization do

not have any effect on government debt.

Results from 〈Table 1〉 shed another insight into the investigation of the compensation hypothesis. The compensation hypothesis posits that there is a positive correlation between globalization (or openness) and government expenditure. From the results of models (4) and (5), we can see that social and political globalization do not have any fiscal effect. The results show that, among many aspects of globalization, opening up to a world market (i.e., economic globalization) has a profound impact on domestic government policy. The globalization variable from model (1) is an aggregate measure that is composed of economic, social, and political aspects of globalization. While social and political globalization did not prove to be important separately, the aggregate globalization turned out to have a positive effect on government debt. How can we explain this? It can be said that the economic aspect of globalization trumps the non-significance of social and political globalization or there is an unknown feature of ‘combined’ globalization that is clearly different from economic globalization alone. There is a possibility that the ‘risk’ from outside perceived by people of a country can be reinforced by not only economic openness but also

Table 2. Results of panel regression analysis

Variables	(1)	(2)	(3)	(4)	(5)
Globalization	1.4656*** (.5326)				
Economic Globalization		.7640** (.3037)			
Trade Openness			.3856*** (.1016)		
Social Globalization				.7290 (.6099)	
Political Globalization					.1969 (.2796)
Research and Development	-9.7019* (5.4241)	-8.2716 (5.4498)	-8.7597 (5.6830)	-8.2104 (5.1515)	-7.5622 (5.7636)
Old Population	5.7044*** (1.7579)	5.7226*** (1.9876)	4.9386** (2.2201)	5.1244** (1.9251)	6.0927*** (2.0963)
Unemployment Rate	1.4495** (.6242)	1.4901** (.6510)	.8942 (.6481)	1.4548** (.6604)	1.4686** (.7041)
Social Welfare Expenditure	2.1467* (1.1368)	2.4836** (1.2059)	2.8993** (1.2398)	1.6567 (1.0477)	2.2588* (1.2544)
Overall Income Tax Rate	.3533 (.2355)	.2632 (.2369)	.2848 (.2552)	.3171 (.2423)	.2827 (.2630)
Gross Domestic Product	.0171*** (.0028)	.0154*** (.0028)	.0168*** (.0031)	.0162*** (.0029)	.0158*** (.0031)
GDP per Capita	.0045 (.0470)	.0265 (.0473)	-.0261 (.0452)	-.0018 (.0491)	-.0032 (.0509)
Voice & Accountability	-1.5197 (8.3362)	-.5154 (8.9120)	-.8731 (8.700)	-2.4826 (8.8775)	-3.9003 (9.5259)
Political Stability & Absence of Violence	3.6363 (3.0524)	3.3665 (3.2595)	3.8863 (2.9880)	3.9725 (3.2430)	4.3749 (3.2860)
Year Dummies	Yes	Yes	Yes	Yes	Yes
F Statistic and Prob. > F	24.60 (.0000)	19.60 (.0000)	31.03 (.0000)	34.18 (.0000)	21.71 (.0000)
Hausman Test P-value	<.0000	<.0000	<.0000	<.0000	<.0000
No. of Observations	294	294	294	294	294

Notes: Dependent variable is general government debt-to-GDP ratio. Estimators are from linear panel regressions with country-fixed effects. Constant is omitted. Heteroskedasticity robust standard errors in parentheses. ***: significant at 1% level, **: 5% level, *: 10% level.

social and political awareness of globalization.

Another point to think about is the difference between the magnitude of coefficients on the KOF economic globalization and openness variables. We can see that the coefficient on KOF economic globalization is greater than the coefficient on openness variable. As noted previously, the definition of openness is (export+import)/GDP and this measure can easily be made with data available in national economic account. However, KOF economic globalization is comprised of actual various flows of trade and level of formal and informal trade barrier, which makes it more

attractive measure than openness. This result suggests that even if two variables measure a similar concept, the effect of each variable can be different according to specific factors incorporated into each variable. It emphasizes the importance of creating a more comprehensive and appropriate measurement for empirical analysis.

For other control variables, as was the same with our expectations (share of old population, unemployment rate, and social welfare expenditure) they show a positive and statistically significant effect on government debt. Especially the effect of the share of the older population (age 65+) is noteworthy.

The magnitude of coefficients on the older population variable is the greatest of all variables. Additionally, the coefficients are statistically significant at least at a 5% level in all specifications, which suggests that the problem of the ageing population has a significant fiscal implication. This is the same problematic social phenomena that South Korea is currently experiencing. The size of a country's economy, which is represented by the GDP variable, also had a positive effect on government debt. This result adds to the argument that the bigger the economy, the more need for government spending for various services. There does not seem to be an economy of scale. It also suggests that small countries have relatively more fiscal leeway than large countries. GDP per capita, which represents how much a country is wealthy, does not seem to have an effect on government debt. OECD countries are relatively wealthy compared to other countries and that is probably why the effect of the level of wealth is not visible in this sample.

IV. Conclusion

Using data from the OECD countries, this study tried to answer the question whether globalization could be a source of fiscal crisis. For this, this paper empirically investigated the relationship between the levels of general government debt-to-GDP ratio and globalization measured by different globalization indices. The 'Compensation Hypothesis' argues that there would be a positive relationship between globalization and the size of government because the government would try to mitigate the risk coming from an outside force through expanding the size of government. Many previous

studies have put this argument to the test, but there has not been any empirical consensus about the possibly detrimental fiscal effect of globalization.

The main results of this study are as follows: Globalization measured by the KOF globalization index has a positive and statistically significant effect on general government debt-to-GDP ratio. The KOF economic globalization index and trade openness variables also turned out to have a positive effect on government debt. However, social and political globalization did not have any effect on government debt. These results corroborates the argument of the compensation hypothesis and also emphasize the importance of the economic aspect of globalization that could trigger fiscal crisis. Other variables such as the share of the older population and the size of the economy measured by gross domestic product, as expected, had a positive and consistent effect on the level of government debt.

This study used a sample of the OECD countries, since these countries are relatively wealthier and have a more mature economy than other developing countries, which could mean greater fiscal problems. South Korea is a member state of the OECD, and the results of this study should provide a valuable policy recommendation for fiscal issues. In addition, this study used a new and classified measure of globalization to test the validity of the compensation hypothesis. This study partially supported the argument of the compensation hypothesis and showed a possible link between globalization and fiscal crisis. This study also showed different results according to different aspects of globalization, which distinguishes the results of this paper from those of previous works. However, to provide more

insight into the investigation of this issue, expanding the size of the sample beyond the OECD countries and using a more detailed measure of globalization would be a good extension of this study.

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세계화는 어떻게 재정위기를 초래할 수 있는가?

– 보상가설에 대한 실증분석 –

국문초록 세계화가 국가와 각국 정부의 국내정책에 미치는 영향에 관해서 지금까지 많은 연구가 이루어져 왔다. 그 중 ‘보상가설’은 국내경제의 국제시장으로의 노출 정도와 정부의 크기에 양의 상관관계가 있다고 주장하여 세계화와 재정위기간의 잠재적 연결고리를 제공하고 있다. 보상가설의 주장은 각국 정부가 세계화가 국내에 미치게 되는 불평등의 심화 등의 부정적인 영향을 정부지출을 늘림으로써 보상하려고 시도한다는 논리에 기초하고 있다. 하지만 보상가설에 관한 선행연구들은 일관된 실증분석 결과를 얻지 못하고 있는 실정이다. 이 연구는 보상가설의 유효성을 기존 연구와 다른 변수를 이용해 새롭게 실증분석하였으며 분석결과 경제적 세계화와 무역개방성 변수들이 OECD 국가들에서 정부부채에 통계적으로 유의한 양의 상관관계를 가지고 있는 것으로 나타났다. 그러나 사회적 세계화와 정치적 세계화는 정부부채에 영향을 미치지 못하는 것으로 분석되었다. 이 연구의 결과는 세계화의 경제적 영향이 국가의 재정 건전성에 큰 영향을 미칠 수 있으며 이는 미래의 재정 위기의 단초가 될 수 있음을 시사한다.

주제어 : 보상가설, 세계화, 재정위기

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