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Government Consumption Volatility and Country Size

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NON-TECHNICAL SUMMARY

This paper provides empirical evidence showing that smaller countries tend to have more volatile government consumption for a sample of 160 countries from 1960 to 2000. While Alesina and Wacziarg (1998) robustly show that smaller countries have higher levels of public consumption as a share of GDP, to the best of our knowledge, the impact of the size of nations upon the volatility of government consumption has not yet been discussed in the literature.

From a business cycle perspective, some government consumption volatility may be positive if fiscal authorities use expenditures counter cyclically to smooth out the effects of economic shocks. However, most of the existing empirical studies finds that higher volatility of public consumption impacts negatively on economic growth and welfare (see, among others, Fatás and Mihov, 2003 and 2005; Furceri, 2007; Afonso and Furceri, 2008; and Loayza et al., 2007).

We argue that a negative relationship between government consumption volatility and country size can be mainly explained by two reasons: i) to the extent that government spending is used for fine tuning purposes, the size of a country acts as an insurance against idiosyncratic shocks, leading to a less volatile government spending; ii) increasing returns to scale of government spending originating from higher ability to spread the cost of financing it over a larger pool of taxpayer, allow the government to provide the public good in a less volatile way.

Our empirical finding is robust to different time and country samples, different econometric techniques and to several sets of control variables. In particular, disaggregating government consumption by function, it emerges that government consumption spending in all functions is more volatile in smaller countries. In addition, our empirical analysis shows that the discretionary (not reacting to the state of economy for fine tuning purpose) government consumption volatility is also decreasing with the size of nations.

This paper, therefore, highlights the need for small countries to smooth government consumption in order to improve their economic growth prospects. In addition, to the extent that large fiscal areas reduce government consumption volatility, our findings reinforce the role of fiscal coordination and/or fiscal federalism in monetary unions.

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