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Globalisation and Income Inequality: An International Perspective

By

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GLOBALISATION AND INCOME INEQUALITY:

AN INTERNATIONAL PERSPECTIVE

by

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AN INTERNATIONAL PERSPECTIVE

Introduction

Internationally, I believe that globalisation has had and will continue to have tremendous benefits for all countries that participate. However, it does create pressures leading to increased inequality in some countries and the need for structural adjustment in all. Moreover, globalisation leaves some countries more vulnerable to external economic shocks. Hence, globalisation poses risk management challenges that have not yet been adequately addressed. In particular, have to understand better the risks faced by the poorer and less-skilled members of society and their difficulties in coping with economic change and shocks and assist them to manage them. We also need to understand better how structural change in economies affects the impact of globalisation.

Those countries that do not participate in the globalisation process will certainly be the poorer for it and fall further behind. Smaller countries have the most to lose from not participating—though not necessarily the most to gain—and they can develop the greatest vulnerability to external shocks if they do participate. Therefore, risk management is most important for them. Finally, globalisation has in the past been a ‘fragile flower’ that is easily broken, with devastating consequences, and unless the risks that accompany globalisation are managed well—including its potential for creating income inequality—it could be reversed again.

Before going on to amplify these points, I discuss what is meant by globalisation—or, at least, what I mean by it. I also wish to say more generally what has been happening with respect to income inequality internationally, particularly in the so-called developing countries.

Globalisation

Globalisation has in some quarters become almost a term of abuse and is being charged with many if not most of the world’s current economic problems. I take globalisation to mean the process of closer economic integration between countries; closer integration in terms of trade in goods and services, in investment (both fixed investment and portfolio investment), in the free movement of labour (in some cases such as the European Union), in the adoption of common currencies, and in joint international action on cross-border issues such as pollution. The main drivers of the large increase in international trade and investment—which to many is the main manifestation of globalisation—have been the international agreements to free up trade (the GATT and regional trade agreements) and the rapid reduction in transport costs, particularly the costs of transporting information. These factors, together with the opening to foreign investment, has led to what is a new phenomenon in globalisation, which is the fragmentation of industry.

With countries more open to trade and investment, the greatly reduced costs of sending information around the globe has reduced the costs of managing geographically-dispersed parts of a firm. This has allowed managers to locate different parts of a production process in those countries where the process can be carried out most cheaply. Through this process, fragmentation has allowed host countries to pursue their comparative advantage and thereby make the best use of their resources. There are, of course, other factors contributing to the international relocation of investment, such as “tariff jumping”, but I believe that they are of second-order importance.

For lower-income, or developing countries, being allowed expanded opportunity to exploit their comparative advantage through the fragmentation of industry or through taking advantage of freer trading opportunities, often means being given the opportunity to develop labour-intensive industries, i.e., taking advantage of their relatively large endowments of low unit cost labour. The export of labour-intensive goods has been the basis for the fast economic growth rates experienced by most of the rapidly growing developing countries of the past 30 years. But freeing up the import of these goods into the high-income countries has been a source of increasing income inequality in these countries, with the inevitable resistance by those losing out.

The freer flow of capital internationally could well be a more important dimension of the recent globalisation trend in terms of its impact on the structure of economies and the shocks experienced by countries. As yet, however, we understand little of the economic changes brought about through the substantial increase in international capital flows, including the impact on income inequality. Its impacts are not as obvious as the impacts that the international flow of goods appear to have, but they could well be more important; such as through the impact on taxation, on the stock of skills and technology of a country, and the shocks from sharp changes in the directions of capital flows. For example, the international mobility of capital means that there is strong pressure for taxation rates on capital to be internationally competitive.

Income Inequality

Concerns about increasing income inequality have become much more loudly proclaimed and more widespread over the past 20 years. The 1980s was widely seen as the “decade of greed” with much concern about the high incomes earned through dealings in the financial markets. Rising income inequality doesn’t generate concern only in the high-income countries, as in fast-growing developing countries the fast growth has been soon accompanied by worries about growing income inequality. What has really been happening internationally as far as income inequality is concerned? Should increasing income inequality be of such concern?

First, it is necessary to distinguish between what is called absolute poverty and income inequality or relative poverty. These terms are too often confused. Absolute poverty is where people do not have sufficient access to food, shelter, and clothing to provide a basic level of physical and mental development. Absolute poverty levels can be compared across countries. Relative poverty is an income inequality measure whereby

an arbitrary income level is set as the level below which people in the particular country are considered to be poor. Therefore, so long as relative poverty lines continue to be drawn, poverty will always be with us—as noted in the Bible. But absolute poverty can be removed from the face of the earth, and has been in many countries—Australia included. Prime Minister Hawke was stating a truism when he said that no child would be in poverty in Australia by 1990, if he was referring to absolute poverty.¹ But his goal can never be reached if he was referring to relative poverty.

As I say, much has been made of growing inequality throughout the world. I would like to briefly present what I believe is the true picture of what is happening within and between countries. There is no doubt that between the richest and the poorest countries the gap in average incomes has been widening. But statistics provided on the basis of particular “countries” are very misleading in this case. First, countries have moved from the poor to the rich group. For example, South Korea was one of the world’s poorest countries in the 1950s, but with 20 years of very fast growth behind it, it is now an OECD member. Second, and more important, global welfare should be measured in terms of people, not countries. China and India together account for close to half of the world’s population. Both have been increasing their per capita GDP very quickly in recent years, much faster than the high-income countries. If the provinces of China were treated as separate countries, the 20 fastest-growing economies in the world between 1978 and 1995 would all have been Chinese (World Bank 1997). For 500 years, under closed economic systems of various forms, China managed to keep its per capita GDP at around an absolute poverty level of US\$500 per year. The World Bank now estimates China’s per capita GDP in Purchasing Power Parity terms (i.e., the best basis for international income comparisons) at around US\$3,000 per year. India’s real GDP growth since adoption of economic reforms in 1991 has averaged around 7 per cent annually. From 1985 to 1993, life expectancy in India rose from 55 to 62 years and, importantly, women now live longer than men. In terms of population, therefore, incomes have been converging, i.e., income inequality has been declining.

The absolute poor (defined by the World Bank as people trying to live on US\$1 a day or less) are said to be rising in terms of numbers of people, with recent estimates of 1.3 billion in this state (World Bank 2000). I find these numbers hard to align with the foregoing statistics on China and India and with statistics that say that over the past 30 years life expectancy in developing countries has increased from 41 to 62 years; and that infant mortality has halved in that time.

Have incomes been converging or diverging within countries? Within developing countries, research has not been able to find any systematic relationship between economic growth and changes in income inequality (Bruno, Ravallion and Squire 1998, Deininger and Squire 1996, Chen and Ravallion 1997, and Dollar and Kraay 2000). In

¹ UK Prime Minister Blair’s stated “historic mission” is to end child poverty by 2020. However, a recent Unicef report claims that Britain’s relative child poverty tripled over the past 20 years as income inequality widened.

fact, income inequality within developing countries largely appears to be stable over time (World Bank 2000).

In high-income countries, there appears to have been increasing inequality in some cases, e.g., the Netherlands, Norway, the UK and the US, but not in Canada and France. Atkinson (1999) shows that the most significant part of the increase in wage inequality in the UK and the US has been the increase of the top decile of income earners relative to the median, not to the bottom decile.

I am very suspicious of the statistics on real wages for countries such as the US that claim the real wages of the lowest wage earners to have been declining as I doubt that price changes are being measured well. It seems to me that measurement of prices presents a very difficult problem that has not been solved when up to 75 per cent of an economy is comprised of services. For most services the output is valued at the cost of the inputs, i.e., we cannot measure changes in the quality or value of output and therefore cannot obtain a price for a unit of service of given quality.

Moreover, measurements of incomes are usually on the basis of wages or wage rates. More and more people have diversified income sources, with income from capital as well as from labour. This presents a particular problem in measuring household incomes in farming (where most of the poor are to be found in developing countries). Household income may be made up of on-farm and off-farm labour income as well as on-farm and off-farm capital income.

Should we worry so much about income inequality? Unfortunately, Marx was correct on one point at least; in large part, people judge their welfare in relative terms. This is why political envy is such a powerful weapon for politicians. So, no matter how wealthy we become, manipulative people will continue to tap into this dark well of the human psychology. Of course, it is illogical, but emotions often override logic and rationality.

Globalisation and Inequality

What role has globalisation played in changes in income inequality? Most research on this issue has been concentrated in recent years on the changes in income inequality in the high-income countries, and in particular in the US and the countries of the European Union (EU). Discussion has mainly focussed on whether the widening wage gap in the US or the increasing unemployment in the EU is due to increased imports of labour-intensive goods from developing countries (pushing down demand for low-wage labour) or technological change—in particular, improvements in information technology (increasing demand for high-skilled labour relative to demand for low-skilled labour). But besides these two factors, other factors thought to contribute are: slower growth in the supply of skilled workers (pushing up their wages relative to the wages of less-skilled workers); increased workforce participation of women and increased immigration of low-skilled workers (pushing down wages of less-skilled labour); and the waning powers of trade unions (for a survey of the literature, see Tyers, Duncan and Martin 1999).

Good arguments can be made for a contribution by all of these factors to increasing wage inequality or increasing unemployment in countries such as the EU, US, or Australia. Economics research generally gives more support to improvements in technology as being most important, and much more important than increased trade with developing countries (see Tyers, Duncan, and Martin 1999). The volume of trade does not appear to be large enough for increased trade with developing countries to be the main factor; moreover, the timing is wrong. Low and middle income countries account for about 80 per cent of the world's industrial workforce and manufactures comprise about 60 per cent of their exports (up from 20 per cent in the 1960s). However, their exports of manufactures account for only 2 per cent of the GDP of high-income countries, with the GDP of such countries now comprising some 70 per cent or so of services. Therefore, some other factors must be more important in explaining increasing wage inequality. As far as the timing of the growth in wage inequality in the US is concerned, US trade with developing countries grew much faster in the 1990s than in the 1980s, while most of the rise in wage inequality was in the 1980s.

Atkinson (1999) shows that the most significant part of the widening inequality in the UK (which has experienced the largest increase in wage inequality in the high-income countries) and the US is the increase in the highest-income earners' incomes relative to those of the median. Atkinson suggests that this movement in the UK and the US has been due in large part to the shift to performance-related pay in countries such as the US, whereas Canada and France have not moved so far in this direction. However, Katz and Autor (1999) explain the different behaviour in income inequality in Canada and the US as the result of the supply of educated workers rising much faster in Canada than in the US. The supply of highly educated workers has also grown rapidly in France.

Atkinson (1999) also suggests that the same forces driving economies to give more emphasis to performance-related pay have also led to less willingness to impose high marginal tax rates and thereby make disposable incomes more equal than pre-tax incomes. As a result disposable incomes have become more unequal in some high-income countries. The move to performance-related pay and the reluctance to impose high tax marginal rates could also be forced upon countries because of the greater international mobility of capital and skilled labour. Therefore, there is pressure for tax rates to be internationally competitive, which is another aspect of globalisation.

In line with predictions from economic theory, Williamson (1997) argues that the increased flow of labour-intensive goods and unskilled labour from developing countries to high-income countries in the latter half of the 20th Century reduced demand for low-skilled labour in the high-income countries, increasing income inequality in these countries. He argues that this is consistent with the Heckscher-Ohlin trade model that says that trade will tend to equalise factor payments, leading to greater cross-country income equality for low-skilled labour, increasing income inequality in the high-income countries, and increasing income equality in the lower-income countries. More importantly, he notes that in the earlier golden period of globalisation (1870 to 1913), the growing income inequality in the then higher income countries led to the reversal of globalisation (including restrictions on immigration) and the devastating 1921-38 period.

Williamson raises the question of whether the income distribution impact of the current ongoing globalisation will have the same result. Certainly, the disappointing results of the WTO's Seattle meeting do not bode well.

The large number of competing explanations for the increases in income inequality in some of the high-income countries indicates how difficult it is to understand what has happened. It is important, however, to try to clarify the situation. Otherwise, there is the danger that globalisation will be incorrectly blamed and the argument will be used to overturn the global integration that has provided the main avenue for the poor developing countries to raise their living standards.

Globalisation should not be contributing to income inequality in developing countries, except where the country experiences external shocks as a result of the greater openness to trade and investment. The answer to this problem is not to reverse globalisation but to find ways to manage the risks introduced by greater openness. While globalisation should be leading to greater income equality in developing countries through raising the wages of the less-skilled, domestic policies are likely to be the main factor leading to any increases in inequality. Globalisation obviously has nothing to do with any growth in the numbers of absolute poor in the lowest income countries that have been falling further and further behind in terms of per capita GDP. Quite the opposite, in fact, as these countries are not participating in the globalisation process at all. Where, as in so many cases, we see widening gaps between urban and rural incomes, discrimination against the agricultural sector, including industrial and trade policies promoting capital-intensive, urban-based industries behind tariff barriers, are usually the main culprits. The end result is rural-urban drift, with the rural poor becoming the new urban poor. For example, Sub-Saharan African countries now have up to 40 per cent of their population living in urban areas.

Discussion

There is one clear result from recent research on poverty, which is that there is a strong association between economic growth and the reduction of absolute poverty. If openness to trade and investment are important contributors to economic growth, then it is important to continue the process of globalisation and encourage the poorest countries that are not participating to do so. However, while the extent of the impact is not at all clear, such openness does contribute to wage inequality in some high-income countries. As well, the rapid economic growth in developing countries that can result from openness will mean rapid structural adjustment as well as greater exposure to external shocks. These issues pose challenges to be met through policies to manage the adjustment costs and the increased risks, especially for the poor. The smaller the country, the more it has to lose by not participating in the globalisation process, though small countries probably don't gain as much as large countries from globalisation. Small countries have to be open economies in order to enjoy rapid growth, as they cannot take advantage of economies of scale except by trading in world markets.

The call for international wage “standards” is rather ironic as what is being denied through free trade, i.e., cross-country equalisation of wages for people of the same skill level, is to be enforced through trade penalties. However, attempting wage equalisation in this way flies in the face of economic logic that says that wage levels have to be consistent with productivity levels. Increased living standards cannot be decreed.

While the implications of the reduction of barriers to trade have been subject to considerable research and are reasonably well understood, the implications of increased openness to capital are not so well understood and could have more important ramifications than liberalising trade, such as its impact on fiscal policies. However, while the freedom of movement of goods and services and capital does expose countries to external shocks, the same freedom allows them to manage these risks through international risk management markets such as commodity and currency markets.

What are the implications for the WTO? The antipathy towards globalisation is placing great pressure on the WTO process of multilateral trade liberalisation. However, it seems that the WTO could learn some lessons from the economic reforms undertaken in developing countries over the past 20 years. First, trade policy reform is one of the most difficult kinds of reforms to implement because, as Rodrik (1994) says, the gain in efficiency from trade reform is small in relation to the income redistribution effect. Second, where particular reforms are seen to be difficult to implement it may be best to undertake a “package” of reforms in which the losers from one part of the reform package gain from another (see Haggard and Welsh 1996). Third, “ownership” of reform programs are seen to be essential and cannot be imposed from outside (Burnside and Dollar 1997). Taking note of these three lessons may mean that the WTO process of trade liberalisation should change. For example, the WTO process may need to be better integrated with individual country reform programs. The WTO may be better seen as a means of “locking-in” unilateral reform packages, rather than being negotiated and imposed in a “top-down” process.

What is the likelihood of a global turning-back from globalisation as happened early last century? The process of global integration has gone much further than it did in the 1800s, with the fragmentation of firm activities. Also, there is a much larger proportion of people around the world whose prosperity has resulted from globalisation. These factors may make a reversal of globalisation much more difficult than previously.

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