

# Globalization and Inequality

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## I. Introduction

The processes of global economic integration initiated in the 1960s have deeply impacted economic well-being across the globe. A number of observers identify these processes as an important factor contributing to the expansion of inequality within and between countries. In contrast, proponents argue globalization stimulates economic growth and allows poor countries to “catch up” to the West, contributing to cross-country income convergence. While the latter perspective focuses on between-country inequality, critics emphasize both within country *and* between-country inequality.

Underlying these issues is the question of why economic policies and processes should be evaluated on the basis of their contribution to equality. There are several reasons economists and policy makers should be concerned with trends towards greater inequality. Within countries, inequality of income, wealth, and education creates distance between groups that can undermine social and political cohesion, lead to policies that differentially benefit dominant groups to the detriment of low- and middle-income groups, and slow the process of economic development and growth. We therefore have good reason to worry about the effects of globalization on inequality within countries. Moreover, between-country inequality is a breeding ground for global political instability, and undermines the post-colonial goal of rectifying the negative impacts of 19<sup>th</sup> and 20<sup>th</sup> century colonialism and imperialism.

This paper explores the effects of globalization on the distribution of income and well-being, first by briefly describing three key facets of economic globalization – trade, investment, and financial liberalization. I then discuss various methods for

measuring inequality and poverty and provide some data on trends. This is followed by a discussion of the pathways by which aspects of liberalization have contributed to inequality. Finally, I consider the impact of inequality on the possibilities for economic development and growth of poor countries, emphasizing that there is a two-way causality between growth and inequality.

## II. Economic Globalization Since 1960: What Has It Entailed?

The term “globalization” is generally used to refer to a set of macro-level policies and regulations that affect cross-border transactions, resulting in increased interdependence among countries and their citizens. The recent round of globalization began in the 1960s although it is not the first episode of global economic integration. Indeed, as Raphael Kaplinsky (2005: 22) notes, trends in global economic integration reflect the “breathing of the global economy,” that is, the tendency for growing and contracting degrees of integration. The slave trade that began in the 15<sup>th</sup> century marked an earlier period of globalization with the exchange of people as property, primary commodities, and manufactured goods between Europe, Africa, and the Americas. The late 19<sup>th</sup> century and early 20<sup>th</sup> century marked a more recent period of globalization in which international migration figured in an important way.

To shed light on the impact of the current period of globalization on distribution and poverty, I discuss investigate the degree if market liberalization and government disengagement in three key areas: trade, foreign direct investment (FDI), and finance.

### *Trade*

Regulations on trade, that is the movement of goods and services across borders, have diminished substantially since 1960, taking the form of reduction or elimination of tariffs and quantitative restrictions on imports. Tariff reductions raise the demand for imports since they lower the consumer price of imports. Trade liberalization also includes the elimination or reduction of export taxes and

subsidies. Developing countries are especially affected by this trends. Governments in agricultural economies, for example, typically levied export taxes as an efficient means to collect tax revenues in the absence of a well-developed administrative system to collect income and sales taxes. Export subsidies (from the government to the exporting firm) were also used to lower the sale price of exports and thus increase foreign demand for exports.

While the overall trajectory has been towards trade liberalization, especially the reduction of tariffs, the goal of “free trade” has been unevenly pursued, at least partially reflecting the relative bargaining strength of poor and rich countries. The World Trade Organization (WTO) has been key in the push for trade liberalization although additional pressures are transmitted via bilateral trade agreements between rich and poor countries. Agreements reflect the differential bargaining power of rich countries to shape trade rules according to their domestic interests rather than pursuit of a universally applied goal of “free” trade. A prime example is the intransigence of the US and Europe in maintaining substantial import tariffs on agricultural goods to protect their farmers from import competition from lower income countries.

As a result of a variety of factors, not entirely due to trade liberalization, there has been a significant increase in the exchange of goods and services across borders. A useful measure of this trend is exports as a share of gross domestic product (GDP). Over the period 1960 to 2005, the share of exports in world GDP rose from 12% to 27% (World Bank, 2008a). For East Asia and the Pacific, trade as a share of GDP reached 47% of GDP by 2005. This trend implies that economic performance at the national level is more interconnected with the conditions in the global economy than in the past, such that economic crisis on the far side of the globe can impact the domestic economy, despite any responsibility for the crisis. The global economic crisis of 2008 makes this clearer than ever, as poor countries, which are now deeply tied into the US and European economies experienced sharp declines in export demand as rich countries went into a precipitous downturn in that year.

Proponents of unqualified market liberalization argue that it promotes economic efficiency by allowing countries to specialize in the production of goods that they can produce most cheaply, and then trading. Because this is argued to lead to improved productivity (implicit in the notion of efficiency), proponents maintain that trade liberalization also stimulates growth. This is based on the assumption that low prices reflect *only* efficiency, ignoring the possibility that prices may also be low as a result of discrimination, weak bargaining power of workers, absence of safety and health standards, or environmental pollution not reflected in the cost of the goods. This stance further assumes that there is full employment, thus ignoring the possibility that some workers who become lose their jobs as demand for the goods they produce falls with trade liberalization may not be able to find new employment.

### *Investment*

Investment liberalization involves the reduction of host country restrictions or conditions on foreign direct investment. Constraints on multinational corporations' (MNCs) decision to invest abroad are eased in a variety of areas. Local content requirements in the past required foreign firms to source locally for a percentage of the inputs used in the production of their goods. This encouraged backward linkages into the domestic economy, creating more employment locally. Some countries also required that MNCs form joint ventures with local firms to encourage the development of entrepreneurial skills in the domestic economy, thus intensifying the positive spillover effects from FDI. Finally, many countries restricted the percentage of MNC profits that could be repatriated to the home country. This restriction was intended as a means to promote further investment in the domestic economy.

Bilateral trade agreements as well as WTO rules now require countries to relinquish such conditionalities on FDI. The stated goal of investment liberalization is to stimulate FDI to developing countries since deregulation renders investment potentially more profitable. The WTO has taken this several steps further by, for example, prohibiting governments from discriminating against foreign investors

through the establishment of "national treatment" clauses. These clauses require governments to extend subsidies or tax benefits to foreign firms that are offered to domestic firms.

More far-reaching protections for multinationals are embodied in the WTO's Trade-related Intellectual Property Rights (TRIPs) agreement. This agreement is responsible for extending patent rights to 20 years. For some countries, this amounts to greater regulation, not deregulation, given that prior to the TRIPS, the use of patented knowledge in a number of countries extended for only 10 years. Patent protection artificially raises the price of a good by essentially giving monopoly rights to the owner of the patent, not infrequently large multinational firms. As this example suggests, it would be a mistake to see the current period of globalization as one of unadulterated deregulation, given efforts to re-regulate in some areas, largely to the benefit of MNCs based in rich countries.

The changes in rules governing cross-border investment have resulted in an expansion of FDI since the 1960s, with an increasing share going to low- and middle-income countries. That said, FDI is not widely dispersed in the developing world; most goes to just 10 countries. Of significance, however, is that now firms possess more options, should local cost conditions not be favorable. This raises their bargaining power relative to governments in negotiations over taxes, and relative to workers, whose ability to bargain for wage increases is reduced, given their immobility relative to capital.

#### *Financial Liberalization*

Financial liberalization entails the reduction of restrictions on moving money across borders (capital controls) and the removal of controls on interest rates. It has further been associated with the emergence of "independent" central banks. Central bank independence reflects the separation of a central bank's mission and decision-making from that of the government. A result of this shift is that central bank goals have become more tightly focused on keeping inflation low and close to zero, with less emphasis and sometimes abandonment of the goal of employment generation or pursuit of a government's development goals, including industrial policy.

Reduced regulation in these three areas—trade, investment, and finance—has circumscribed the state’s role in managing economic development and growth, and ability to stabilize domestic economies. Equally important for the impact on distribution, these intertwined processes have paved the way for the expansion of global production networks that influence the relative bargaining power of MNCs, their subcontractors, and workers in poor countries in ways that help to explain some of the global trends in question. We discuss these issues in more detail below, but first turn to a discussion of how to define and measure inequality and poverty.

### III. Inequality and Poverty: Measures and Trends

#### *Inequality amongst whom?*

Distribution and inequality differ according to the group(s) under consideration. Much of the research on the inequality effects of globalization has focused on household income distribution (also called the size distribution of income), based on data from household expenditure surveys. An alternative measure of inequality is the distribution between wages and profits. This has also been termed the functional distribution of income insofar as it represents the share of national income going to the factors of production, labor and capital, thus capturing the degree of class inequality.

In addition to these measures, there may be systematic inequality between other groups in society based on ascriptive characteristics, such as gender and race/ethnicity. Measures of intergroup inequality may capture forms of stratification not evident in the size and functional distributions of income. And of course, measures of inequality between countries can tell us a good deal about the impact of differing macroeconomic policies and strategies, and the effects of globalization.

#### *Inequality of what?*

Assessments of trends in inequality and poverty rely primarily on monetary measures of well-being. This raises concerns, however, since money is only a means

to an end of well-being and quality life. Nevertheless, income can serve as a useful, if imperfect, proxy for assessing how well families are able to provide for themselves and their children, and more generally, the quality of life when other data is scarce or unavailable.

Income inequality indicators offer a means to assess the economic distance between the groups. Several measures are based on group shares of total income. One method, the quintile approach, is measured as the ratio of the income share of the richest and poorest groups, for example, the top 20% compared to the bottom 20% (sometimes deciles are used in place of quintiles). The higher the ratio, the greater is the degree of income inequality. This measure is easy to calculate, and it helps to focus attention on the distance between richest and poorest, although it ignores changes in income share of those in the middle of the distribution. An alternative measure that uses all available information about household or individual income, including those in the middle, is the Gini coefficient. The Gini coefficient ranges from a low value of 0 (perfect equality) to a maximum of 100 (perfect inequality where one household or family has all of the income). Some scholars measure the Gini on a scale of 0 to 1.

The data in Table 1 provide examples of both methods for calculating inequality for selected countries. Note the wide variation across countries that are at similar levels of development. Despite the predictions of Simon Kuznets many years ago that income inequality rises and then falls with development, the data suggest inequality is not necessarily related to a country's per capita GDP. Rich and poor countries alike may have unequal distributions. The data in Figure 1 plot per capita GDP in 2007 (measured in natural logarithms) against the Gini coefficient for the countries whose data are shown in Table 1. At first glance, the data seem to be consistent with the Kuznets hypothesis. However, within income groups (low-, middle- and high-income countries), there is significant variation in the degree of inequality. The implications of this are that a variety of macro-level policies play a role in influencing income distribution.

Insert Table 1 here.

Insert Figure 1 here.

Inequality can also be measured as group differences in capabilities. Capabilities may be defined as the pre-conditions for people to live well and to be positioned to adequately provide for themselves and their families. Commonly-used measures of capabilities are educational attainment, life expectancy, and maternal and infant mortality rate. The advantage of using capabilities measures in place of income is that they are better able to capture the effect of public expenditures on such things as rural health clinics and public education that improve well-being beyond the income available at the household level. The Human Development Index (HDI) combines both income and capabilities into a single index. That said, most capabilities measures change slowly or with a lag in response to adverse economic conditions, and as a result, are less helpful than income for tracking the impacts of economic volatility. Also, data on educational and health inequities at the household level are not as widely available as income data.

Measures of intergroup inequality are most easily expressed as ratios of group averages or log differences of group averages. As an example, gender wage inequality can be measured as the ratio of the average female wage to the average male wage. Because wages are calculated as averages, this measure does not tell us a great deal about within group distribution. (There are methods to account for within-group inequality, however, if desired). Similarly, racial/ethnic inequality could be measured as, say, the ratio of income, wages, or even life expectancy of one ethnic group to another.

#### *Trends in inequality*

Scholars have debated whether or not inequality has increased during the latest period of globalization. The Gini coefficient tends to be the most widely used indicator in scholarly research on trends in inequality. Recall that the Gini coefficient measures inequality based on the distribution of income across the entire population, whether at the country level or globally. Using that measure, scholars have developed three conceptual indicators of inequality trends over time. The first,

called Concept 1 inequality is a global Gini coefficient, based on estimates of the country mean of per capita GDP by country. This measure is a useful way to observe trends in gaps between countries, where each country gets one vote, so as to assess tendencies towards or away from convergence amongst countries' mean incomes. Concept 2 inequality uses the same per capita GDP data, but weighted by each country's share of global population. In practice, that implies that trends in India and China have a big impact on this measure of inequality, given the relative size of their populations. Finally, Concept 3 inequality captures not only inequality between countries but also within countries, relying on national household expenditure and income surveys. That is, with these data, a Gini coefficient can be estimated that conceptually, is obtained by lining up individuals across the entire globe from poorest to richest, and calculating the Gini coefficient, based on income shares of quintiles or deciles of the population.

Before we turn to a discussion of trends in the Gini coefficient across countries, it is useful to discuss another point of contention in the inequality debate, which is the methodology for converting countries' per capita GDP, all measured in local currency, to a single international currency so as to facilitate cross-country comparisons. One approach is to use market exchange rates. A second is to use purchasing power parity (PPP) exchange rates. PPP is a technique that estimates the cost of the same basket of goods across countries, capturing the effect of differences in prices on the buying power of an individual's income. For example, Indonesian per capita income is lower than, say, per capita income in South Korea. However, prices for commonly-consumed goods and services are also lower in Indonesia, so the currency goes further there. This suggests that a comparison of Indonesian and South Korean incomes, converted to a common currency, will overestimate inequality. PPP is used to adjust exchange rates so that they reflect a common purchasing power.

There are some criticisms of the PPP methodology. An important one is that the basket of goods used to derive PPP includes a wide variety of goods (steel, cars, and so forth). But the poor spend income only on narrow subset of the entire bundle

of commodities in PPP indices. As a result, the PPP basket of goods does not accurately reflect the consumption priorities of the poor.

Recent efforts to improve the quality of the data used to calculate PPPs were undertaken in 2005, covering 146 countries (World Bank 2008). The new estimates yielded substantially higher prices of goods in a number of very large countries. As a result, per capita GDPs have been adjusted downward from the old PPPs for a number of countries: by 38% in China, 31% in Vietnam, 37% in India, and 40% in Philippines. The new round of PPP estimates that has led to such a dramatic revision of per capita GDPs (and by extension, poverty rates) lends weight to the criticisms of PPPs as a reliable basis for comparing incomes across countries, and should suggest the need for a degree of caution when using such data. It also attests to the fact that other non-income measures should be used to supplement income-based measures of poverty and inequality.

Two recent *Human Development Reports* (1999 and 2005) published by the United Nations Development Program (UNDP) provide data on trends in the ratio of the income share held by the top 20% of households across the global compared to the bottom 20%. Those data are shown in Figure 2, and demonstrate a widening global gap between richest and poorest that has accelerated since the 1960s. While reasonable people may debate whether widening income gaps in the last three decades can be attributed to globalization, it is patently clear that global inequality has widened.

Insert Figure 2 about here.

Milanovic (2009) has recalculated global Gini coefficients, using the new PPP data, to assess trends in global income inequality from 1952 to 2006, the first year for which data on China are available. His results for Concept 1 inequality show that from 1960 to 1980, inequality was relatively stable with a world Gini of about 53. Thereafter, inequality widened, peaking at 57 in 2001, which is substantially higher than its value of 47 in 1950. Weighting a country's GDP with its population (Concept 2), however, we observe that inequality has fallen since 1950. This is

largely due to rising income in China; the exclusion of China results in a trend of rising inequality from the early 1980s.

Within countries, there is also evidence of widening income inequality. According to the International Labor Organization (2008), over 70 countries experienced worsening inequality from 1990 to 2007, as measured by the Gini coefficient. The trend of widening inequality within countries is also evident in measures of the functional distribution of income, that is, the share of the national income going to workers vs. employers. The ILO (2008) has found that the share of wages in total income declined over the past two decades in 51 out of 73 countries for which data are available. The rapidly-growing Asia and Pacific region was not spared in this expansion of inequality, experiencing a 10-percentage point decline in labor's share of income from 1990 to 2007.

Inequality in China has been rising over the last two decades as well. Some attribute this trend to the migration of rural workers to urban export manufacturing jobs where pay is higher. The growth of inequality, in this view, would be amongst workers, with the expectation that over time as structural change occurs with the growth of the industrial sector, inequality will automatically decline. Galbraith, Hsu, and Zhang (2009) dispute that view at least for the post-2000 period. They pinpoint the growth of inequality to speculative finance, associated with China's building boom, rather than the growth of manufacturing employment.

### *Poverty*

Poverty rates measure the adequacy of income of the poorest amongst us. We can measure that income in absolute terms against the cost of a basic needs budget, or relative to the income of the entire population. In the former case, the cost of a basic needs budget differs across countries and there is no internationally recognized methodology to calculate this. Instead, by default, the World Bank and others use a threshold of \$1.25 a day in PPP terms, or, alternatively a \$2 a day threshold.

Relative poverty is measured as the share of the population whose income is less than half the median income. This measure implicitly recognizes that economic inequality can lead to social exclusion of the lowest income groups, preventing them

from full participation and voice in social and economic life. While this is a very useful measure as it captures both poverty and inequality, only a few countries, primarily in Europe, employ this measure. Unemployment is a key factor in social exclusion in rich countries, but other aspects of poverty play a role; lack of income to afford basic necessities that fit within social norms, such as adequate clothing, schooling, and housing, for example, can lead to exclusion from social and economic participation. While I note this measure for academic reasons and because of its potential value, it is difficult to use for cross-country comparisons over time, due to lack of data.

The World Bank's \$1.25 and \$2 a day poverty estimates are widely cited, and its methodology has received a great deal of scrutiny. Therefore, I review poverty trends using the Bank's revised estimates, based on new PPPs from the International Comparison Project whose goal is to develop and refine methods to compare the purchasing power of incomes for comparisons between countries using purchasing power parity exchange rates (Chen and Ravallion 2008).

#### *Critiques of the World Bank Poverty Estimates*

Before a consideration of trends, it is useful to review the criticisms of the Bank's poverty measures. A major criticism of the World Bank poverty measurement methodology is that the poverty thresholds – \$1.25 a day or \$2 a day – are arbitrary, and are not linked to estimates of the cost of meeting basic needs (Pogge and Reddy 2008). The Bank counters that its extreme poverty threshold of \$1.25 a day is based on the national poverty thresholds in the 15 poorest countries. However, that threshold is clearly inapplicable to higher income countries, and thus global poverty is likely much higher than the Bank's estimates. Indeed, studies that develop poverty thresholds based on estimates of the cost of a basic needs budget find that poverty is significantly higher than official poverty rates. As an example, in the US, basic needs budgets have been developed to determine a wage level that would be considered a "living wage." The poverty rate resulting from the use of a basic needs budget approach was 30.0% in 2002-03, a rate that is significantly higher than the official rate of 9.2% for that year (Hoffer, *et al.* 2003; DeNevas, *et al.* 2004).

Moreover, income is a means, not the end in itself. Critics therefore argue that to assess well-being, we should measure the ends themselves, to include for example, health and educational attainment. The UNDP's *Human Poverty Index* is an example of an effort to overcome the deficiencies of a purely income based poverty measure, and includes assessments of survival, education, and a decent standard of living measured as share of the population with income less than half the median national income.

#### *Trends in Poverty*

Estimates based on new PPP data show an increase in the absolute number of poor, defined as people living on less than \$2 a day, from 1981 to 1999. This was followed by a decrease in the number of poor so defined up to 2005, so that that by that year, the absolute number living in poverty is roughly equivalent to the 1981 number (Figure 3) [Chen and Ravallion, 2008]. There are as yet no global estimates that capture the impact of the global financial crisis that began in 2008. As would be expected, China's large population has a significant impact on the numbers. If our interest is in comparison of the impact of macroeconomic policy on countries in the globalization period, it is instructive to consider trends that exclude China. As the data in Figure 3 show, without China, the absolute numbers living in poverty globally have risen.

Given, however, that populations are increasing, we also want to evaluate trends in the probability of being poor, that is, the poverty rate. There, the news is better, at least for some regions. The data in Figure 4 show a dramatic decline in poverty rates in the East Asia and Pacific region over the period 1981 to 2005, based on \$2 a day threshold. Poverty rates have fallen in most other regions though less dramatically, with the exception of Sub-Saharan Africa with stagnant poverty rates over this period. In fact, the number of poor people in that region nearly doubled, from 200 million in 1981 to 380 million in 2005, using the \$1.25 threshold. For the developing world as a whole, poverty rates have also fallen but again, when China is excluded, the trend is less positive.

Insert Figures 3 and 4 about here.

The case of China has been pointed to as an example of the benefits of globalization. From 1981 to 2005, 500 million people have been raised out of poverty based on the \$2 a day threshold, with the poverty rate falling from 97.8% to 36.3% (Chen and Ravallion, 2008). Bardhan (2010) challenges this view, pointing to the fact that more than half of this poverty reduction occurred in the pre-reform period that began in 1987. Bardhan argues that the most significant policy change that led to poverty reduction was land reform in the agricultural sector, not market liberalization. Decollectivization and egalitarian land reform based on equally distributed land rights, as well as government policy that raised the price of grains paid to farmers, were key.

Further doubt is cast on the benefits of globalization, based on trends in well-being measures. Weisbrot, et al (2007) produce a “scorecard on development,” comparing trends in a variety of social indicators during the pre- and post globalization periods, 1960-80 and 1980-2005, respectively. In addition to observing a slowdown in economic growth, the authors find that the pace of improvements in health outcomes has decelerated from the earlier to later period. Amongst the indicators they reference are infant mortality rates, adult mortality rates, and life expectancy. There has also been a decline in public spending on education, and not surprisingly, a slowdown in improvements in enrolment in primary and secondary education. Major exceptions are India and China, two countries that have not entirely or even substantially adhered to the precepts of market liberalization that characterize the most recent period of globalization. These countries are discussed in more detail below.

#### IV. The globalization and inequality debate

##### *The Pro-Globalization Economists' Viewpoint*

I briefly rehearse here the arguments in favor of globalization, as this perspective has received much more attention in academic and policy circles. Proponents of

globalization (defined as market liberalization and a reduced role for government in regulating market activities, influencing prices, and directing the development process) argue that it will lead to a reduction in inequality. This is premised on a neoclassical theoretical framework whereby unrestricted markets are argued to lead to the most efficient allocation of resources by fuelling competition amongst self-interested, profit-maximizing parties. Competition, it is argued, forces agents to reduce costs of production, stimulating innovation and thus increasing the efficiency of production.

Trade liberalization, it is argued, is beneficial because it allows countries to specialize in the production of goods they can produce most cheaply, trading these to obtain goods that other countries can produce at a lower cost than they themselves can. Trade contributes to efficiency, and as a result, expands global output due to gains from specialization and because the per unit cost of production falls as the scale of production expands. Proponents of free trade debate this issue as if there is a one-size-fits-all strategy that is beneficial to all countries, regardless of their economic structure and international conditions – and that strategy is to eliminate all restrictions that would impede trade, including tariffs. While the debate centers on a free trade or autarky (self-sufficiency) dichotomy, in reality, trade policies can span a spectrum along a continuum from little management or intervention (freer trade) to managed trade (regulation of exports and imports) to self-sufficiency.

Investment liberalization, assumed to increase foreign direct investment (FDI), is argued to benefit poor countries by increasing their access to best-practice technology that multinational corporations (MNCs) bring. That can lead to spillover effects to the rest of the economy, as domestic firms imitate foreign firms, adopting new technological practices, and thus raising economy-wide productivity. Further, because foreign investment augments domestic investment, it can stimulate job growth.

Financial liberalization, similarly, is assumed to contribute to higher productivity investments and thus output. This occurs because liberalization allows surplus funds to reach the highest rate-of-return projects (which are by implication,

the most productive) across the globe. This stance is premised on the view that government controls on the movement of money across borders can limit the ability of financial markets to match financial investors with worthy borrowers. Financial flows, it is argued, will be drawn to capital-scarce poor countries because of higher rates of return on investment than in capital-abundant rich countries. The stimulus economic resulting from increased financial flows to poor countries will increase their rate of growth and thus employment. As a result, global inequality is predicted to fall.

Neoliberal commitment to market liberalization is augmented by a view that government intervention into the functioning of the economy should be relatively circumscribed. This is because government planning and subsidies are viewed to be unguided by the profit motive and therefore can lead to waste. Corruption, the use of government power and control over resources to obtain to illicitly acquire income, is also a concern of neoclassical economists that colors perceptions of the effectiveness of government intervention. The example of Latin American governments' efforts to reduce dependency on foreign imports through their import substitution industrialization (ISI) strategy from the 1930s through the 1970s is often cited as a case in point. Several major Latin American governments used a variety of tools to promote industrialization in strategic areas: restrictions on imports of manufactured goods, dual or managed exchange rates, and restrictions on foreign direct investment. ISI, however, was argued to lead to higher consumer costs, inefficiency, and corruption, rather than increased productivity and economic growth.

### *The Critics of Globalization*

Among the numerous criticisms of globalization, a major concern has been the inability of liberalization to reach its stated goal of increases in employment and economic growth, as well as a concern with the unfavorable effects of market liberalization on the distribution of income and well-being. A further worry is that the neoliberal policies in this current period of globalization can lock poor countries into an unequal and disadvantaged position relative to rich countries.

A related critique relates to pro-globalization economists' one-size-fits-all time-invariant policy prescriptions. Critics point out that policy choices are in fact not dichotomous (free trade or self-sufficiency) but rather lie on a continuum from greater to lesser regulation. Where a country falls on that continuum should be the result of a deliberative process of evaluation, based on the end goal not of "free" trade or "free" markets, but rather the improvement of living standards, broadly shared, as well as economic security. Thus, trade and investment rules should be conceived of as tools, not ends in themselves. Policies that might benefit one country's development goals may not be appropriate for another country, with a different production mix, institutional environment, and stage of development.

While trade and investment liberalization are often undertaken simultaneously and it is in fact impossible to analyze the effects of each in isolation, critiques of globalization tend to focus on discrete policy areas. I therefore discuss here the critiques of trade, investment, and financial liberalization separately to elucidate their particular contribution to inequality and poverty to the extent possible.

#### *Trade Liberalization*

Proponents of globalization promote the benefits of economic integration, based on expanding exports and imports. Whatever goods a country produces for export, however, export dependence can lead to economic instability that results from disruptions in global demand due to factors beyond the control of the domestic economy. The impact of the global financial crisis on developing countries is a case in point. Middle- and low-income Asian economies experienced a precipitous decline in their exports, on the order of 40% in 2008, with the recession in the US and Europe. For countries that can afford extensive social insurance programs (such as unemployment benefits, well-funded worker retraining programs, food and housing subsidies), there is a greater possibility for families to smooth incomes and consumption during crises.

But it is primarily rich countries that have such insurance funds, and even within rich countries, disproportionately women and ethnic minorities tend to have

less access to social insurance and safety nets, and thus face severe economic hardship during downturns. The poorest countries are doubly vulnerable to export surges and declines because, due to low per capita incomes and government revenues, social insurance programs are limited in scope and depth. Where insurance exists, it primarily applies to the formal sector of the economy and disproportionately covers men rather than women who tend to be concentrated in the informal sector.

An emphasis on global economic integration under current rules of the World Trade Organization (WTO) and bilateral trade agreements with rich countries also make poor- and middle- income countries susceptible to declining terms of trade that their balance of payments and slow economic growth. The Singer-Prebisch thesis describes these dynamics, which are attributable to the differing price and income elasticities of demand of goods that less developed countries export and import. The original thesis referred to the tendency for poor countries to specialize in commodity exports, while importing skill- and capital-intensive goods (principally manufactured goods). Because commodities are homogenous goods for which there are ready substitutes and for which demand tends not to rise with incomes over time, such as for food, commodity export prices tend to fall or rise much more slowly than the price of sophisticated manufactured imports which are more income-elastic (as income rises over time, demand increase). As a result, poor countries locked into commodity exports face declining terms of trade: prices for imports of skill- and capital-intensive manufactures rise over time, requiring a country to give up more exports to purchase the imports it receives.

The macroeconomic effect of this trend is that leakages from the domestic economic for imports rise, producing a negative effect on aggregate demand. Of course, developing countries could respond by lowering the price of exports and/or increasing production of exports in order to afford the rising cost of sophisticated manufactured exports. However, the nature of the goods that poor countries export is such that lower prices have little effect on demand, so that export revenue falls. Further, prices tend to be supply-determined such that increases in production

drive down the global price of these goods, leading to a further deterioration of the terms of trade and what Jagdish Bhagwati termed “immiserizing” growth.

In recent years, it has been recognized that labor-intensive light manufactured goods (e.g., garments, shoes, toys) are similar to primary commodities in their homogeneity, and as a result, there are many close substitutes, which holds down the price these goods fetch. In part, this problem relates to the “fallacy of composition,” that is, the constraint imposed by numerous developing countries simultaneously exporting similar types of manufactured goods to industrialized country markets. The result has been overproduction of light manufactures, leading to falling prices of light manufactures, with exporting countries facing declining terms of trade. Kaplinsky and Morris (2006) have found evidence, for example, that the 2004 dissolution of the Multi-fiber Agreement, which eliminated developing country quotas of garment exporters to rich countries, led to an expansion of Chinese exports to rich countries. As a result, Sub Saharan African garment and textile exports decreased 17% in 2005 alone, leading to substantial job losses (Kaplinsky and Morris 2006).

One solution to the trade-development-growth trap is for developing countries to shift to production of skill- and capital-intensive goods for which demand is rising as global income increases. Movement up the industrial ladder to sophisticated manufacturing is key to structural transformation of developing economies, as this can stimulate productivity growth in other sectors. In order for that to happen, however, countries require policy space to create the conditions for firms to technologically upgrade. Domestic firms require “breathing space” from MNC competition so that they have the opportunity to learn by doing, which raises firm productivity and competitiveness. Under the right conditions, then, domestic firms can become competitive in global markets, and their manufacturing know-how can spillover to the rest of the economy, stimulating productivity growth in other sectors and fuelling economic growth.

This pathway to development and growth has been blocked due trade rules imposed via bilateral trade agreements and the WTO. In the words of Ha-Joon Chang, rich countries have “kicked away the ladder” from developing countries,

Stephanie Seguino 6/14/10 10:24 AM

**Comment:** Insert citation for Chang's book Kicking away the ladder.

having climbed the industrial ladder themselves to achieve global competitiveness. Due to the resulting roadblocks, today's poor countries are stuck in the production of export goods whose prices are declining relative to those of sophisticated manufacturing goods, contributing to widening of global inequality. It is worth noting that most of the poor countries that have successfully industrialized over the last four decades, thus escaping the problem of declining terms of trade, are those that ignored many of the precepts of neoliberal globalization policies. South Korea, Taiwan, Japan, China, and India have all had significant state intervention directed towards managing trade, circumscribing foreign direct investment, and using a variety of policies to "get prices wrong" in the words of Alice Amsden (1989). These successfully stimulated investment and growth in strategic industries, thus contributing to dynamic comparative advantage.

Apart from hamstringing the ability of countries to move up the industrial ladder with the attendant higher per capita incomes, trade liberalization reduces tax revenues available to developing country governments for investment in infrastructure, health, education, and research – all expenditures that could stimulate private investment and raise economy-wide productivity (Khattry and Rao, 2002). This occurs for two reasons. First, trade liberalization results in cuts in tariffs, a major source of developing country government revenue. (Trade tariffs are administratively easier to collect than income or sales taxes in developing countries). Second, insofar as trade liberalization results in job losses, incomes fall and thus so do tax revenues. These income losses can have negative effects on within-country inequality. Government spending is an important mechanism for providing a cushion in times of economic crisis and redressing income and social inequalities by funding education, rural health clinics, immunizations, for example. Trade liberalization undercuts the ability of governments to carry out these functions, and can worsen class and gender inequality in education and health outcomes.

Critics of trade liberalization do not argue that countries should revert to self-sufficiency, closing off exchange with the rest of the world. Rather, it is argued that uninhibited trade liberalization can undermine broadly shared well-being.

Instead, it is argued, trade must be managed strategically to create dynamic comparative advantage and to reduce volatility of incomes and unemployment. In particular, trade rules should be adapted to the particular conditions of a country, based on the types of goods that it exports and the state of competition in the global economy. In some areas, such as food production, for example, countries may desire to promote food security, reducing vulnerability with respect to the vagaries of the global market and the weaker bargaining power that a country experiences when it is dependent on imports to supply necessities.

#### *Investment Liberalization and Firm Mobility*

In the debate on globalization, the effects of investment liberalization are often analyzed separately from trade and financial liberalization. In reality, however, these processes are deeply intertwined and their effects cannot be decomposed so easily. Investment liberalization itself has been propelled by trade liberalization. Firms can now shift production from rich countries to poor countries (or between poor countries) to take advantage of lower costs and higher profit opportunities. They can then export their goods back to the home (rich) country without concern for trade quotas or tariffs, as had been the case in the past. Further, financial liberalization makes it easier for them to obtain financing in host countries.

In theory, liberalization of rules on foreign direct investment could result in increased inflows of funding to host developing countries to set up businesses and generate employment. Several problems with the relaxation of rules on foreign direct investment have emerged, however. Foreign firms often fail to use best-practice or frontier technology in their overseas production facilities. Their reluctance is due to the desire to minimize dissemination of their production strategies and proprietary knowledge, thereby limiting competition and ensuring a continuation of monopoly rents. The spillover effects of FDI to host country productivity may thus be very limited, suggesting that FDI liberalization may contribute little to closing income gaps between countries.

Further, while MNCs in many cases pay higher wages than local firms, their presence can inhibit wage growth. This is because the elimination of regulations on

FDI, coupled with financial and trade liberalization, has resulted in greater firm mobility. That is, it has become easier for firms to relocate to other countries, should local regulations or costs become less favorable. Because investment liberalization expands a firm's locational options, as compared to workers', their bargaining power vis-à-vis workers has increased. Specifically, firm mobility results in an enhanced "threat" effect that limits working bargaining power in negotiations over wages and work conditions. Specifically, with investment liberalization, firms can now credibly threaten to relocate if workers do not accept wage cuts or wage freezes, for example.

The depressing effect of firm mobility on wage growth has been empirically confirmed in developing countries (Bhattacharya and Rahman 1999; Seguino 2007) as well as rich countries (Choi 200). The effects in the US are particularly stark. We tend to think that wages will rise along with labor productivity. So long as wage and productivity growth increase at the same rate, prices to consumers do not rise and profits do not fall (unit labor costs are constant). However, since the mid-1970s in the US, although productivity has continued to rise, wages stopped growing in real terms and in fact began to fall (Figure 5). Globalization, which raises the bargaining power of firms, has made it harder for workers to demand a share of the revenue generated by productivity growth. The mirror image of the slowdown in wage growth in the US over the last three decades is the rise in corporate profits, and thus the profit share of income.

Insert Figure 5 here.

Firm mobility in developing countries appears to have contributed to a slow down in productivity growth, via the depressing effect of mobility on wages. In essence, it would appear that firm mobility and the resulting low wages make firms "lazy", or less inclined to innovate and seek other methods to raise productivity in order to lower costs and achieve competitiveness. Why would firms prefer low wages to innovate as a method to lower costs? In a globally competitive environment with increasing volatility and vulnerability to shocks, firms run a

greater risk of being unable to recoup on their investment costs for new technologies or in worker training. For some firms, especially those that produce labor-intensive goods, it may be easier to rely on lowering wages as a way to maintain competitiveness. Nevertheless, the very negative net effect is that wage *and* productivity growth are slowed with increased firm mobility. The result is greater inequality (profits rise while wages stagnate), and economic growth is slowed as productivity growth stagnates.

In addition to these problems, liberalization of trade and investment has led to reorganization of global production with implications for inequality. Over the past three decades, we have witnessed a phenomenon alternatively described as firm disintegration, outsourcing, or global commodity chains (Sayeed and Balakrishnan 2002; Milberg 2008).

Global commodity chains fall into two groups—producer-driven and buyer-driven (Gereffi 1994). Producer-driven chains are those with a parent company that is a large, usually transnational, manufacturing firm that plays the central role in coordinating production networks. This is characteristic of capital- and technology-intensive industries such as automobiles, aircraft, computers, semiconductors, and heavy machinery, which outsource the production of various components of the final product. The web of production then includes the parent company, subsidiaries, and subcontractors the globe over. The parent company fully specifies the components to be produced and subsidiaries and subcontractors compete primarily on the basis of price and quality.

Buyer-driven commodity chains refer to those industries in which large retailers, marketers, and branded manufacturers play the pivotal role in setting up decentralized production networks in a variety of exporting countries, typically located in developing countries. This pattern of industrialization, propelled by trade liberalization and the search for lower production costs, has become common in labor-intensive, consumer goods industries such as garments, footwear, toys, and consumer electronics. Developing country subcontractors make finished goods for large buyers, typically located in rich countries. Just as in the producer-driven

chains, the large retailers or marketers that order the goods supply the specifications to subcontractors.

One of the main characteristics of the firms that fit the buyer-driven model, including retailers like Wal-Mart and J.C. Penney, footwear companies like Nike and Adidas, and fashion apparel companies like Kathy Lee and Liz Claiborne, is that these companies design and may market, but they do not themselves engage in production. They are part of a new breed of “manufacturers without factories” that separate the physical production of goods from the design and marketing stages of the production process (Gereffi, 1994).

In both buyer- and producer-driven commodity chains, parent companies or branded manufacturers are in the driver’s seat. Because they determine the specifications for products, engage in product design, and are the link between developing country producers and rich country consumers, they possess significant market power. As a result, the profit margins of subcontracting firms are razor-thin (Heintz, 2006). With pressure on their profit margins, developing country producers working at the tail end of the supply chain have the incentive to squeeze workers’ wages. Moreover, most do not have the resources to invest in productivity-enhancing improvements to the production process. Thus, similar to the structural tendency we observed above with production by mobile MNCs, we observe low wages and slow productivity growth in developing countries and international inequality in global commodity chains.

Firm mobility can also contribute to downward pressure on government revenues. This is because firms are able to credibly threaten to relocate if governments do not offer tax holidays that are commensurate with those offered by other countries. The net effect then is that firm mobility is yet another source of downward pressure on government revenues that could be used for social investment and to promote economy-wide productivity growth through investment public goods such as roads, ports, irrigation, and immunization. Governments also are under pressure to lower labor standards and, more generally, make labor markets more flexible as a way to lower labor cost and thus attract foreign investments. We see evidence of this in Export Processing Zones, set up for

assembly production in developing countries, with many restricting the rights of workers to organize.

### *Financial liberalization*

Financial liberalization (FL) refers to the reduction of credit and interest rate controls; decreased barriers to entry for foreign financial institutions; liberalization of the capital account, that is, the movement of money across border; and deregulated capital markets. The theoretical motivation for financial market liberalization, in particular deregulation of the movement of money across borders, is as follows. Poor countries lack sufficient savings with which to invest in expanding production. And yet, at early stages of economic development countries are in dire need of financial capital because domestic savings are low. Financial liberalization, it is argued, will allow savings to flow to the highest rate of return investment, usually in poor countries that are capital-starved where therefore the rate of return will be higher. Since capital is scarce in poor countries, interest rates (the rate of return on investment) are higher than in rich countries, where capital is more abundant.

While there are potential benefits from financial liberalization, there are also countervailing costs that pro-globalizationists place little emphasis on (Ghosh 2005). One of the most significant, as evidenced by the Tequila crisis of 1994 and the Asian financial crisis of 1997 is increased macroeconomic volatility due to sudden reversals of capital flows that can lead to painful currency devaluations. Some crises result from the effects of governments pulling back from regulation of credit allocation which has contributed to the rise of short-term speculative investment into areas such as real estate in lieu of long-term productive investment in manufacturing or agriculture.

While pro-liberalization forces argue that countries may protect themselves from sudden capital outflows by promoting sound macroeconomic policies – low inflation, small public sector budget deficits, high levels of foreign exchange reserves and a flexible exchange rate, sudden reversals of inward capital flows are often a result of destabilizing speculative activity, unrelated to underlying macroeconomic

conditions in a particular country. Unregulated financial markets respond to real data about economic conditions and risk. But they are also susceptible to irrational decision-making, based on fear or even exuberance, and are often not grounded in real macroeconomic fundamentals. Without the means to regulate capital flows, psychological phenomena can drive flows in very damaging ways.

Sudden currency devaluations that result from speculative attacks on a currency and subsequent capital outflows increase the risk of bankruptcy for both banks and businesses. Domestic banks face higher repayment costs for offshore loans denominated in foreign currency, for example. Further, some central banks have responded to capital outflows by raising interest rates in order to entice foreign capital back into the country. But those high interest rates are an excessive burden on domestic firms, and can lead to widespread bankruptcies with massive layoffs. Further, devaluations make imports more costly, even while they make exports less costly to foreign buyers. That can be disastrous for developing countries that have “rigid” imports (that is, a dependence on imports that are necessities such as oil, imported intermediates, medical supplies for which there are no domestic substitutes). Depreciations (or devaluations) that result from a financial crisis then can cause the balance of payments to worsen further, as the trade balance deteriorates.

Increased macroeconomic volatility due to financial market liberalization affects the poor and women more harshly than the wealthy and men. In some countries, such as the US, it also affects ethnic minorities more harshly than dominant ethnic groups. In all cases, this is because groups that are lower in the economic hierarchy have fewer savings and other assets that can help smooth consumption during crises that are characterized by the widespread destruction of jobs. Men tend to be employed in jobs that offer benefits and social insurance, thus providing a social safety net. In contrast, women and ethnic minorities in the formal sector tend to be employed in insecure or part-time jobs. In many developing countries, women are heavily concentrated in the informal sector, and these jobs tend not to be covered by social insurance. Further, whichever sectors face the largest job losses during an economic crisis, gender norms and ethnic hierarchies

are such that women and ethnic minorities tend to be first fired in some countries. Men, particularly those of the dominant ethnic group, are frequently perceived to be the legitimate jobholders when jobs are scarce. This suggests that inequality rises during times of economic crisis, and in particular, both racial and gender inequality are likely to increase.

Financial liberalization, according to proponents, offers the promise of more rapid growth rates in developing countries due to the increased access to foreign savings and investment this affords. However, liberalization may lead to the opposite effect – a slowdown in economic growth, a problem that economists call a deflationary bias. How does this occur? First, in a global economy with liberalized financial markets, wealth holders are free to roam the globe in search of the highest rate of return on their investments. Central banks are therefore under pressure to raise interest rates to attract portfolio investment. However, higher interest rates are a cost of doing business, and therefore dampen business investment, slowing job creation.

Second, financial markets fear inflation since it reduces the real rate of return on investments (that is, the nominal interest rate minus the rate of inflation). Hence, governments are under pressure to keep budget deficits low because financial markets see these as possibly leading to inflation. This is particularly harmful for African countries, since much of investment is public sector-led. Infrastructure needs are great and can “crowd in” private investment, reducing the cost of doing business. But financial market liberalization makes it hard for governments to provide the level of debt-financed public investment needed to stimulate private sector investment and thus job growth. Further, pressure on countries to liberalize financial markets extends to the banking sector, with the IMF and World Bank pressuring countries to adopt “independent” central banks, that is, central banks that pursue low or zero inflation targets rather than linking credit policies to a government’s development strategy.

In contrast to the model of independent central banks, South Korea is widely known to have nationalized banks in the 1960s, and to have used credit policy to target strategic industries for investment (Amsden, 1989). This strategy was key in

moving the economy up the industrial ladder to the production of more skill- and knowledge-intensive goods, with accompanying rising incomes. The economic argument for this strategy is that due to market failures, private firms in developing countries may be unwilling to invest in strategic industries because the initial investment is large and risk is high. Although the social benefits from such investments may be great, private benefits are more limited relative to perceived risk, resulting in a failure of the private sector to invest. Public sector investment or credit subsidies to private firms can help overcome this market failure by socializing the risk. But this avenue to investment growth has been closed off for many countries, due to the pressure for central banks to delink monetary policy from government development policies.

In sum, financial liberalization reduces the two major tools at the disposal of government for stimulating economic growth – fiscal and monetary policy. The evidence of the deflationary bias of financial liberalization is evident in the slowdown of global growth rates since 1980 (Table 2). Over the same period, we observe evidence of an increase in income inequality, with the share of national income going to financial institutions and wealth holders (together these comprise *rentier* income) rising substantially in a number of developed countries (Figure 6). This rise in share of national income going to rentiers coincides with the shift to neo-liberal monetary and financial policies initiated in the US and UK.

Insert Table 2 here.

Insert Figure 6 here.

The costs to workers of this shift were previously discussed, and are evidenced in the falling wage share of income. Among workers, the burdens have also not been evenly shared, but rather are shifted disproportionately to vulnerable groups. Some recent evidence suggests that women disproportionately feel the effects of job losses that result from contractionary monetary policy (higher interest rates) used to quell inflation or expectations of inflation (Braunstein and Heintz 2008). The evidence for developed countries is mixed on gender. Tachtamova and

Sierminska (2009) find no evidence of gender effects of contractionary monetary policy in OECD countries, in contrast to Heintz and Seguino (2009) and Seguino and Heintz (2010) who find consistent evidence that women workers' job losses exceed those of men in response to monetary tightening.

Further, a growing body of evidence finds that the negative effect of fighting inflation by raising interest rates results in greater job losses for racial/ethnic minorities than the dominant ethnic group. In the case of the US, the negative effects on ethnic minorities are stronger than those on women of all ethnic groups (Seguino and Heintz, 2010). Higher unemployment rates for women relative to men and ethnic minorities compared to dominant ethnic group both contribute to intergroup inequality because of the negative effect unemployment has on wage growth.

Apart from the distributional effects of contractionary monetary policy, raising interest rates as a means to address inflation is a policy tool that is insufficiently targeted, and indeed, for developing countries, may be the wrong tool. Higher interest rates are intended to cut aggregate demand in order to control pressure on prices. Yet in many developing countries, the problems of inflation are due to supply side bottlenecks – high food production costs, poor transportation networks, and high labor costs due to pervasive poor health. Those are problems that can be best addressed by public investment, not tight money policy.

#### V. Does inequality affect the rate of economic growth?

The intensification of inequality within countries over the last three decades can influence countries' possibilities for economic development and growth in the short and long run. The precise effect of distribution on the macroeconomy depends on structure of the economy, the stage of development, the production mix, and relations with the rest of the world. In this section, I briefly outline some of the pathways by which inequality can be expected to have macro effects. For more in-depth discussion of distribution and macroeconomic outcomes, the reader is referred to Blecker (1999).

Let us first consider the short run. Much of the research on inequality and short-run growth refers to conditions in middle- and high-income countries. *Profit-led* growth is a condition whereby a redistribution from wages to profits (an increase in the profit share of national income) is a stimulus to economic growth. A useful way to analyze the effects of a redistribution of income in the short-run is by exploring macroeconomic equilibrium condition:

$$I + X = S + M$$

where  $I$  is business investment,  $X$  is exports,  $S$  is aggregate savings and  $M$  is imports.

Using this equation, we can analyze how lower wages (or higher profits) will affect each of the components of aggregate demand. To the extent a redistribution increases  $I$  and  $X$ , relative to  $S$  and  $M$ , aggregate demand and thus short-run growth will be stimulated.

Lower wages (or slow wage growth) can contribute to higher firm profits, thus stimulating greater investment, job creation, and growth. Low wages might also attract foreign direct investment. Similarly, low wages helps to keep the price of exports competitive, thus spurring foreign demand. A redistribution to wealth holders and firms may also raise aggregate saving, if high-income groups have a higher marginal propensity to save. While this contributes to a decline in aggregate demand, it can lower interest rates and thus be a further stimulus to investment. These demand-side effects imply that at least under some conditions, inequality can spur short-run growth.

On the other hand, some economies exhibit features of *wage-led growth*: a redistribution to workers (through higher minimum wages, progressive taxation, or other policies that raise worker bargaining power vis-à-vis employers) stimulates aggregate demand, short-run economic growth and job expansion. This might occur if higher wages raise economy-wide consumption (since workers spend a larger share of their income than the wealthy). It will also depend on the effect of higher wages on business investment. With firm mobility, the negative effect of higher wages on firm profits and thus business investments will be larger than in an

economy with little firm mobility and foreign direct investment. Of course higher wages can also spur labor productivity, although firm mobility undercuts the ability for the benefits of higher productivity on profits to materialize.

What of the impact on exports? In cases where countries produce price-inelastic goods where quality matters (such that higher prices have very little negative effect on product demand) as well as income-elastic goods for which demand rises as trading partners' income rises over time, exports will decline very little as wages rise. Adding up these sometimes contradictory effects, so long as the total effect on aggregate demand is positive, a higher wage share of income will be a stimulus to growth.

The structure of production of many developing countries today as well as trade, investment, and financial liberalization create the conditions for profit-led rather than wage-led growth, making it difficult macroeconomically to reduce inequality. This is because, especially in middle-income countries, export goods are price-elastic and income-inelastic so that higher wages have a larger negative effect on exports. Additionally, firms are more mobile than in the past, and as a result, higher wages can produce significant negative effects on investment, as firms run from higher-wage countries to those with lower wages and fewer labor regulations. Thus, neoliberal policies make wage-led growth much less feasible. The challenge is for countries to create the conditions for a win-win scenario, whereby higher wages are a stimulus to aggregate demand and growth. This will require some re-regulation of capital and trade flows in order to create the appropriate incentive structure for firms to align their private profit goals with societal goals of broadly shared well-being.

#### *Long-run growth effects*

In the long run, the effects of inequality are ambiguous. On the one hand, inequality can lead to a selection distortion problem, whereby rich households will tend to overinvest in children relative to their capabilities, while low-income families will face difficulties accessing credit markets to finance children's education. The result is a lower return to educational investments, with negative effects on economy-wide

productivity. Apart from inequality's harmful impact on economy-wide human capital and labor productivity, it also leads to significant problems at the household level that constrain children's development. Financial insecurity has been linked to substance abuse, domestic violence, child abuse, depression, and other stressors that affect adults, and as a result, children's psychological well-being. Recent research finds that persistent stress and sense of threat in one's environment has long-lasting effects on children's brain development, inhibiting the growth of the hippocampus (Gunnar, Herrera, and Hostinar, 2009).

Poor health is more common in unequal societies (Wilkinson and Pickett 2009). With regard to HIV/AIDS, transmission is facilitated by immune systems weakened by poor nutrition. The long-run effects of HIV/AIDS prevalence in developing countries, including in Sub-Saharan Africa, are strongly negative. Adult mortality from HIV/AIDS reduces household income and food production and the dependency ratio rises (the number of dependents per adult). As a result, children often stop schooling and reduce consumption. With the loss of adults in agricultural communities, the agricultural knowledge base shrinks. The effects are thus short- and long-term.

Gender inequality contributes to the spread of HIV/AIDS. In unequal households, women's weaker bargaining power inhibits their ability to refuse unprotected sex. Further, where inequality in gender bargaining power results in a woman's more limited access to nutrition and health care, her immune system is disproportionately weakened, making her more likely to contract HIV/AIDS. The effects extend to children; loss of their mother can contribute to children's hunger because of decreased means of food production and preparation.

Inequality can, under some although not all conditions, contribute to political conflict that leads to uncertainty, discouraging business investment (Larraín and Vergara, 1998; Nel, 2003). Class inequality in income and wages or due to austerity measures that differentially hurt low-income groups, for example, can contribute to a political backlash. Business investment may decline in response, because conflict contributes to political and thus economic uncertainty, increasing the perceived risk of investment.

On the other hand, wage and income inequality, if not severely resisted (and it may not be, for example, by women, who may be socialized to accept their inferior status), raise profits and can thus stimulate business investment in technology, raising productivity. If this positive effect is stronger than the negative effects on children's productivity and conflict, the net effect is that inequality is a stimulus to economic growth, albeit a growth that is unequally shared.

## V. Conclusion

It should be clear from this discussion that the effect of inequality on short-run growth depends on the structure of the economy, gender and race relations, and patterns of job segregation. Long-run effects, too, appear ambiguous, not only due to the structure of the economy, but also because of contradictory effects of inequality. This suggests that the effect of inequality on the macroeconomy, jobs, and growth may be positive or negative. The challenge therefore is to create a macroeconomic environment that makes it more likely equity is compatible with economic growth and rising living standards. This type of growth has a number of labels (in addition to wage-led growth): inclusive growth, pro-poor growth, and egalitarian growth.

What is required to ensure inclusive growth? The answer to that question depends, once again, on the economic structure of an economy, and the type of equality under consideration – class, race, gender, regional, or cross-country equality. Despite the fact that the specific policy requirements to promote inclusive growth may differ by country, there are some generalizations we can make, based on what we have learned about the effects of market-oriented macro-level policies of trade, investment and financial liberalization.

To summarize, extensive market liberalization can inhibit the capacity of governments to institute policies that would promote equity with growth. The Commission on Growth and Development (2008: 3) itself recognized that public investment is key to growth:

“No country has sustained rapid growth without also keeping up impressive rates of public investment—in infrastructure, education, and health. Far from

crowding out private investment, this spending crowds it in. It paves the way for new industries to emerge and raises the return to any private venture that benefits from healthy, educated workers, passable roads, and reliable electricity.”

Therefore, policies that permit the government to amass the resources necessary to fund public invest that “crowds in” private investment is a first step. How those resources are allocated will influence whether governments also successfully promote greater gender equality, but reducing women’s time poverty due to their care burden, and stimulating employment in ways that offer women equitable access to jobs.

Financial re-regulation (such as, for example, capital controls) can also reduce economic volatility. Accompanying this with a refocused central bank that shifts emphasis from inflation-targeting to targeting lending so as to stimulate jobs growth would be a key step towards inclusive growth. Central banks could, for example, use asset-based reserve requirements and loan guarantees to incentivize private banks to allocate a share of their lending to small- and medium-sized enterprises that tend to be labor-intensive, thus stimulating job growth (Pollin, Epstein, Heintz, and Ndikumana, 2007).

A reconsideration of the goals of trade policy and the role of the WTO is required in order to reduce inequality between countries. Rather than adoption of free trade as an end in itself, countries should focus on the development of strategic trade policies that will help them move up the industrial ladder to the production of higher value added goods in order to raise living standards. Such an approach requires both industrial and agricultural sector policies, and the strategic use of regulation to guide investment, trade, and credit allocation to create dynamic comparative advantage.

The example of several Asian economies testifies to the effectiveness of developmental policies that are flexible and do not rigidly adhere to the precepts of market liberalization. To wit, Japan, South Korea, Taiwan, and now China have experienced sustained upgrading of their industrial structures. The growth strategies of these countries are not without their problems, one of which is relying

to greater or lesser extent on gender inequality to stimulate growth. Thus while industrial upgrading may be a necessary condition for raising living standards, it does not guarantee greater equality. Indeed, as countries upgrade, a process of defeminization occurs, with women's share of manufacturing employment declining as technology-intensive production rises (Tejani and Milberg, 2010).

Thus, in addition to the broad macro policies required to promote equity with growth, gender equality requires a specific set of supporting institutions. To reduce gender equality, for example, requires greater job integration (moving women into "male dominated " jobs and vice versa), and the adoption of state-level care policies that reduce women's unpaid labor burden. It also requires a supportive legal and legislative environment to enforce anti-discrimination policies.

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