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The Globalisation of Inequality

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Abstract

There has been an apparently contradictory trend in the global inequality in living standards over the past quarter-century. On the one hand, global inequality between countries has decreased significantly, while on the other hand, inequality within many countries has increased, particularly in the developed economies. Both of these developments represent an historical shift.

What explains these changes? To a great extent, globalisation is behind both trends. It explains in part the extraordinary South-North catch-up process, and the uneven effects of fundamental structural change in the economies of both North and South. But other factors are also at play.

This paper examines these various factors, the future developments in inequality in the world and the means available to governments to contain national inequalities while still benefitting from the potential economic efficiencies of globalisation.

Keywords

Globalisation, inequality, market liberalisation, deregulation, technological progress, taxation.

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In a human society in the process of unification inequality between nations acquires the same meaning as inequality among classes in the past. Standards of living differ today between continents or between countries more than they ever did. At the same time, the perception of inequality increases whereas resignation to poverty and to destiny is disappearing.

Raymond Aron *The Dawn of Universal History*

There has been an apparently contradictory evolution in the global inequality in income or living standards over the past quarter-century. On the one hand, global inequality between countries has decreased significantly, while on the other hand, inequality within many countries has increased, particularly in the developed economies. Both of these developments represent an historical shift.

Inequality in the world is believed to have grown continuously since the beginning of the nineteenth century, when the industrial revolution sparked the economic take-off of those countries we now call “developed”. While the rate of increase slowed after World War II, inequality in the world reached a level that had probably never been seen inside even the most unequal national community. What we see today is a real historical reversal: in 25 years, the global economy has practically wiped out the increase in inequality in living standards recorded in the previous 60 years.

Now, the reverse is happening inside nation-states. In the majority of countries, inequality has begun to rise after decades of stability. The cases of the US and the UK are well-documented, but we see the same phenomenon to varying degrees in Germany, Italy, Canada, even in Sweden, a country traditionally strongly economically egalitarian, and more recently if more modestly, in France. According to OECD figures, inequality in standards of living increased in more than two-thirds of developed countries between 1980 and 2000. Emerging and developing economies are not exempt from the trend either: income gaps are exploding in China, India and most other Asian countries. The same phenomenon can be seen in several African and Latin American countries, already highly unequal.

What explains these changes? To a great extent, globalisation is behind both of these trends. It explains in part the extraordinary South-North catch-up process and the uneven effects of fundamental structural change in the economies of both North and South. But other factors are also at play.

Economic reforms introduced in China during the 1980s, especially the opening up of the economy to foreign investment and later to global markets, launched more than a billion people into an accelerated catch-up with the rest of the world. The same thing occurred, though at a slower pace, in India after the economic reforms of the early 1990s and the decision to open up what had been a very closed economy to international trade. Thus, the living standards of a total of more than two billion people began to increase at a pace hitherto unknown, and certainly much more rapidly than in the rich countries, precipitating a drop in global inequality. The number of people in the world trying to survive on less than one euro per day, after having increased for several centuries, declined by 500 million in just twenty years.

Of course, there are still far too many poor people in the world (more than one billion), but there are fewer and fewer in Asia. The poorest countries today are in Africa and Central Asia. Some are even poorer than the Chinese and Indians were 25 years ago, which some suggest means that inequality in the world has risen. But the demographic significance of these numbers is too weak to deny the effect of the growth of the Asian giants on the decrease in global inequality. Moreover, we can now see the spill over effect of the large emerging economies on these poor countries. After fifteen years of

stagnation and recession in a great number of African countries, since the turn of the century we have been seeing GDP per capita growth of more than three per cent per annum.

The decrease in global inequality is therefore, above all, the result of a decrease in inequality *between* countries, particularly between rich countries and emerging ones and, more recently, practically all developing countries. This catch-up process has not even been affected by the latest global economic crisis. Growth has slowed, but the difference favouring developing countries remains more or less constant.

This global economic reversal has been accompanied by a substantial and unexpected rise in inequality *within* some countries. There is a sense that we are faced with a situation in which the reduction in inequality between countries is offset by its increase inside national economies. But happily, this match is only partial. The increase in national inequality has so far had little impact on inequality between all inhabitants of the planet. Furthermore, while it is tempting to think that the two trends are linked, globalisation is not their common and single cause. Certainly, globalisation is responsible in part for the catch-up between North and South and can explain the rise in national inequalities in both the North and the South. But there are also other factors, of which some are only indirectly linked to globalisation and others that are country specific.

As far as the developed countries are concerned, first, it is clear that global trade is responsible for profound structural change. The rapid addition of more than half a billion low-skilled Asian workers into global productive capacity has resulted in the transfer of some economic activity to the countries of the South, a geographic relocation of multinationals and a fragmentation of the chain of operations that delivers manufactured goods to end users. In the countries of the North, this has entailed a drop in demand for low-skilled labour, the relative wage rates for such labour and the corresponding rate of employment, potentially contributing to an increase in income inequality and the unemployment rate. More recently, such tendencies have extended to some services, through the subcontracting or outsourcing of tasks such as accounting, statistical treatment, IT development and customer relations (call centres). Competition from emerging economies thus is now affecting skilled labour. We should also note that this extension of manufacturing and sub-contracting in the countries of the South is reinforced by competition between firms in the North and their frantic search for productivity gains, another aspect of globalisation. In any case, the result is that income distribution in the developed countries has had a tendency to distort in favour of those at the top of the income scale to the detriment of those in the middle and at the bottom.

This increase in inequality (mainly in salaries) in favour of the most highly skilled has been reinforced by an increase in profits and return on capital - mostly held by those with the highest standards of living. The slowdown in wage growth for one part of the workforce has systematically contributed to swollen profits. In addition, the geographic redeployment of production has primarily followed an imperative to increase the profits of multinational corporations, clearly the initial inspiration for globalisation. It is scarcely surprising then that ultimately it has benefited their owners.

Several other factors have contributed to the aggravation of inequalities inside developed countries. We cite three. First, rapid technological progress in the last few decades has allowed savings in low-skilled labour, and increased demand for equipment and skilled labour in production activities. It has had similar effects to those created by the extension of trade on the relative costs of these factors. Second, the economies of scale permitted by technical progress have also concentrated the revenues of some activities in the hands of a small number of economic actors: think for instance of the growth in audiences for the stars of cinema, opera, rock music and sport, created by modern communication tools. The increase in the size of big companies that operate globally in turn also (partly) explains the growth in executive salary packages, in the same way as the growing size of financial portfolios explains the huge income and bonuses paid to fund managers and traders. Of course, this expansion in the scale of certain economic activity is not solely responsible for the stratospheric earnings of some

CEOs and stars. Indeed, it multiplies natural rents, like those stemming from the talent of artists or sportspeople, and artificial rents that come with all monopoly situations, collusion agreements and asymmetries in information like insider trading.

Market liberalisation and deregulation constitute a second factor in the aggravation of developed world inequality. Initiated by the Reagan and Thatcher governments at the beginning of the 1980s, and progressively imitated around the developed world, some of the reforms have created monopoly rents where deregulation has not led to competition. The deregulation of financial markets that ended the separation of savings banks and investment banks gave the big banks considerable market power through their deposits, and blackmail potential in a crisis of being “too big to fail”. If we consider the reduction in the rate of unionisation as an endogenous deregulation of the labour market, then we have another example of the unequal effect of some deregulation.

The third factor is taxes and the continual backing away from progressive taxation. On the grounds of economic efficiency and the international mobility of capital and its owners, top marginal tax rates have been drastically reduced in many countries. In the UK, the rate fell from 80 per cent to less than 50 per cent in three decades. The decline was equally dramatic in the United States and even, to a lesser extent, in Sweden. Another reform adopted in several countries has been the decoupling of taxes on labour income and those on capital income, and a related international realignment, so that now the rate of tax on capital income is lower than that on work income.

Are these three developments really independent of globalisation? Not necessarily. The aim of several of the reforms discussed above was to increase the competitiveness of the economies concerned, and we could argue that in a certain way they were also a response to the competition provoked by globalisation. Even technological progress, usually considered exogenous, occurs partly as a result of investments in R&D, which companies made in order to meet the challenge of competition.

Some of these factors are also evident in developing economies, where we see an increase in inequalities, but some are specific to developed economies. At the beginning of the reforms launched by Deng Xiaoping, for example, China was a socialist country, comparable from the point of view of inequality to the economies of northern Europe. Liberalising the economy even partially meant liberating individual initiative and talent, and introducing differences hitherto stifled or erased by the socialist economic system. The same development could be seen in Vietnam and to a lesser extent in India. Yet, the fact that 30 years after the reforms, inequality in China is now greater than in all formerly socialist countries, including Russia, and is approaching the levels in Latin America, the most unequal in the world, suggests that other forces are at work.

There are reasons to believe that at first, inequality grows with development. The population is initially concentrated in the subsistence sector or, in socialist economies, employed in state enterprises. Inequality is low. With development and liberalisation come opportunities for economic gain, which are grasped by a small group of individual entrepreneurs. Peasants migrate to the cities, which are industrialising, but competitive pressure from this quasi unlimited supply of workers restricts the growth of wages. The gains of development are thus monopolised by entrepreneurs, owners of capital and highly skilled workers in short supply. Inevitably, inequality grows, a process that is reinforced by new rent opportunities created by development and inadequately controlled for lack of appropriate governance.

This process of development and growing inequality was described by Nobel prize-winning economists Simon Kuznets and Arthur Lewis over fifty years ago, but they also predicted that the phenomena would return, when the supply of reserve labour was exhausted, provoking an increase in wages and a reduction in profits.

China is close to, or has perhaps already, passed this stage. There is now a scarcity of labour and according to some, in the coming years we should see wages grow faster, inequality recede and the structure of the economy shift in favour of the most technologically advanced sectors. This stage seems more distant for the other emerging powers of Asia.

Several factors could, however, thwart such a transformation. In the first place, Chinese leaders fear that the recent increase in inequality is poised to take social root in the next generation. Second, the global contagion of inflated incomes, thanks to the remarkable mobility of highly skilled labour that drives up the salaries of executive directors, bankers and their deputies in developing economies to the level of those in the rich countries, has spread around the world. Third, there is a fear that the explosion in inequality will create an elite that will progressively take control of the economy. In each of these scenarios, the example of Latin America, where such an elite often blocked development in order to enrich itself, is cause for concern.

Yet, the reduction in inequality in Brazil, one of the most unequal countries in the world just a decade or so ago, presents a different example for consideration. The reduction is a result of a combination of factors, including an ambitious policy of redistribution, three decades of political education, accelerated growth and a demographic shift in low-income families. The distribution of living standards remains highly skewed, but the Brazilian example shows that emerging economies can influence the evolution of inequality without undermining their capacity to catch up with rich countries.

Turning now to the future, what can we predict about the trend towards inequality in the world? And what means do we have at both international and national levels that might reduce or, conversely, reinforce that trend?

Regarding inequality between countries of the world, there is good reason to believe that the historical process of equalisation of the past twenty years will continue, barring a major economic accident in the global economy or certain large national economies, such as a series of natural disasters that would drive the global community to decide to reduce CO₂ emissions dramatically, a violent democratic transition in China that would paralyse the Chinese economy for some years, a major war or financial disaster arising from the bad management of the current European debt crisis. On the other hand, the emerging and developing economies have the capacity to grow even if stagnation or slow growth persists in the developed economies. Indeed, in the future, the largest ones will be able to rely on domestic markets of considerable size and, for the moment, largely under-developed, whereas all countries will benefit from a broadening and deepening of the present progress of South-South trade.

Greater uncertainty surrounds the fate of Africa. Opinions differ as to the reasons for the increased growth in the last ten years (and for some countries, a little longer). Is it the result of better governance and more rigorous development policies and strategies? Or is it simply a consequence of the higher prices paid for raw materials, related to global growth, particularly in the emerging economies? The answer differs from country to country. If the second explanation is true for the majority of countries, then there is a risk that the slowing of global growth in coming years will affect development in poor countries and paralyse a powerful engine for reducing inequality in the world. It should be clear, moreover, that in the long term, an African development based chiefly on rents earned from raw material, mineral or agricultural, is not sufficient in the face of a population growth rate that will not slow down in the immediate future. It is likely then that African economic development is going to be a weak spot in inclusive global development, and that development assistance and other development-friendly policies must be maintained, if not strengthened, so that the aim of reducing global inequality does not run into this obstacle.

The direction of the trends relating to inequality inside national economies depends in the first place on policies put in place to contain or diminish it. We can, nevertheless, say that in the developed

countries some of the forces behind its increase in the past few decades will remain in place. Indeed, it is difficult to see a reduction in the intensity of global competition, especially with emerging economies booming. Under these conditions, the search for competitiveness, to minimise production costs through technological innovation, the increased concentration of the forces of production, and if we do not intervene decisively, the growing dominance of finance, will all apply upward pressure on inequality. These trends will not necessarily be affected by the slowdown in Western economies, which could, rather, exacerbate global competition. In emerging economies, on the contrary, we cannot preclude the possibility that reaching the Kuznets-Lewis rollover threshold will halt or even reverse the increase in basic inequalities and, moreover, that human capital accumulation strategies might also lead to some income equalisation.

This vision of the trend in inequality inside nation-states does not take into account actions that governments could take to remedy existing inequalities or stop them from increasing. Three main types of intervention are possible: income redistribution through taxes and transfers of various kinds; the “redistribution of opportunity” to ensure a better allocation of human capital (that is, through education), greater access to services and facilities, including credit; and finally, the regulation of markets deemed important, such as the labour market and financial markets.

Economic theory emphasises the costs of distortion that can follow the redistribution of current income by changing incentives relating to effort, savings and risk. For example, in a globalising world, greater mobility of people than of capital means that there are costs associated with national taxation regimes more severe than those in other countries. From this point of view, the scope of governments in developed countries to equalise incomes through a progressive income tax is not unlimited. However, the tax cuts implemented in some developed countries over the last 20 or 30 years suggest that a certain margin is still available. This seems *a fortiori* the case in emerging economies where progressive income taxation is still marginal, despite the growing potential for state control that is linked to the development of banking services.

Distributing educational capital more equally, and facilitating access to the means for accumulating other productive assets (entrepreneurship, credit and the like), does not in principle involve the same costs. On the contrary, by allowing individuals to pursue their talent rather than be forced into jobs and skills they do not want, this kind of redistribution improves the efficiency of the economy while in the long term generating a more equal distribution of income. Though strictly speaking, such a strategy is not a direct response to the causes of rising inequality in recent years, it is still likely to erase some of its consequences. However, it requires initial financing by increased tax revenue and does not completely avoid distortion costs.

Intervening directly in markets by regulating their operations can affect more directly the root causes of the recent rise in inequality. But again, we must avoid making inefficient markets. Regulating in order to restore effective competition and eliminate rent-seeking is obviously ideal insofar as it allows us at the same time to restore fairness and efficiency. As already noted, such opportunities are likely to exist in the financial sector. Regarding the labour market, the debate is not settled among economists about the negative effect of regulations such as a minimum wage, which undoubtedly helps to contain inequalities at the bottom of the wage distribution. It depends to a certain extent on the level at which the minimum wage is fixed. Other major interventions such as employment protection do, however, have negative effects on distribution – by creating a dualism between “insiders” who are protected by the legislation and the “outsiders” who are exploited by temporary employers – and on the employment rate.

One type of intervention often discussed in developed economies in recent years consists of introducing a measure of protectionism in foreign trade, especially with those countries in which labour costs are very low. If it were possible, such a policy would likely contribute to an increase in salaries and in the employment of low-skilled workers, but at some considerable cost, starting with the

inevitable reduction in exports to those countries against which the protection measures are taken, and a drop in employment and wages in the corresponding sectors. There would be other equally damaging costs and obstacles. First, if protection is to be exercised against the emerging economies, it would have to be multilateral. And it is not certain that all the commercial partners in a free-trade zone – say, in the European Union – would agree on a list of products against which to protect themselves. Second, many products coming from the emerging economies are mass consumption goods – clothing, shoes, games, electronic goods and the like – which represent an important part of low-income households' budget. Such households might gain in employment and wages, but would lose on cost of living increases.

It is not certain that the final real gains of protectionist policies would be positive because, third, the value chains that lead to end products today are long, complex and increasingly international. The example of an iPhone is well known: it combines essentially American innovation and distribution value with electronic content made in Asia. Protection against Asian production would thus make this kind of product more expensive and reduce sales. Fourth, to regain markets that have been practically abandoned, such as clothing, games and crockery, would demand tariffs so high that national consumers would be the losers. Protectionist measures would have to be concentrated where developed and emerging economies compete, in car production, pharmaceuticals and even aeronautics. But currently, these are also still largely export sectors in developed countries. The final point here then is that gains in productivity and competitiveness in a national economy are in part linked to its export and import activity. Protection against international competition in a range of products would result in an economy turned inwards, locked up and renouncing the benefits of innovations.

In sum, the hypothesis that protectionist policies could correct the relative losses in income for low- and unskilled labour in some developed countries is not realistic because its costs could be exorbitant. There are other, much less expensive, ways to fight inequality, starting with taxation, education and training policies, and the regulation of certain sensitive sectors such as the finance sector. Let's use them.

In conclusion, the apocalyptic vision of a hyper-globalised world in which the differences in standards of living inside a country will be the same as those we see today between countries is fortunately not on its way. We have seen inequality rise in a majority of countries, especially in the developed world. But even in the countries where inequality has most increased (for example, in the United States), the difference between within-country inequality and global inequality remains, with few exceptions, abysmal. We have also seen that while the globalisation of trade, and the increased mobility of labour power and capital are partly responsible for the rise in inequality, they do not explain it entirely. This suggests that there is a separate factor in the trend towards inequality that is at least partly controllable by states.

On the global level, the good news is the decrease in inequality thanks to the historical catch-up of the emerging economies of Eastern Europe, Asia, South America and Southern Africa. On the other hand, there is some fear that the poorest countries might still be lagging behind and risk undermining the process of lowering inequality on a global scale. Happily, the reduction of global inequality is high on the international agenda, as is evidenced by the United Nations Millennium Development Goals.

In the developed countries, the means are available for reducing inequality, and redistribution is already taking place. The problem is that globalisation and international competition will encourage these countries to reduce redistribution – and social protection more broadly – on the grounds that they must defend their competitiveness and that social protection increases the cost of labour. This tendency can already be observed in several countries and it is not independent of the processes of globalisation. Similarly, we must acknowledge that in a globalised world, national fiscal autonomy is limited. Too great a hike in the marginal tax rate can result in flights of talent, capital and businesses to neighbouring countries. However, scope remains for state intervention in the field of taxation, and

considerable progress is still to be made in a number of countries in relation to equal opportunity among citizens and the correction of market imperfections that simultaneously create both too much inequality and too many economic inefficiencies.

The emerging economies constitute a separate case. Rising inequality in those countries persists, and their capacity to favour the redistribution of income, to create equal opportunities and promote good governance, is currently limited. It is to be hoped this capacity will grow with time and economic development itself. Here, the decrease in inequality in Brazil over the last six years is exemplary, even if there remains a long way to go before it reaches the global average.

In sum, the question is essentially political: is there enough political will, in the countries where inequality has risen sharply, to act in order to reverse the trend? At the international level, while the will seems to exist to ensure that poor countries do not deviate from the global economic growth trend, we are apparently still far from such determination when it comes to tackling inequality inside countries and bringing into line, even roughly, taxation regimes. Ultimately, however, such harmonisation may be a necessary condition for the continued pursuit of globalisation and the preservation of its gains.

