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Channels and Policy Debate in the Globalization-Inequality-Poverty Nexus

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Abstract

The paper offers a critical literature review of the debate surrounding the globalization-poverty nexus, focusing on channels and linkages through which globalization affects the poor. After introducing four different concepts used to measure trends in world income inequality, it examines first the 'growth' conduit through which globalization affects poverty. Treating inequality as the explicit filter between growth and poverty reduction, the causal chain of openness-growth-inequality-poverty is scrutinized, link by link. The paper then moves on to examine other channels in the globalization-poverty nexus that operate through changes in relative factor and good prices, factor movements, the nature of technological change and diffusion, the impact of globalization on volatility and vulnerability, the worldwide flow of information, global disinflation, and institutions, respectively. The paper concludes with a discussion of strategic policy issues within the context of the globalization debate.

Keywords: globalization, growth, inequality, poverty

JEL classification: F0, I3, O1

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1 Introduction

Over the recent decades, the world economy has experienced not only a quantitative leap in the volume and value of international trade and financial transactions, but a qualitative transformation in the way residents of different nation-states interact with each other. National economies are increasingly linked through international markets for products and factor, leading to increased cross-border flows of goods, capital, labour, and through flows of information, technology and management knowhow.

This process, popularly referred to as the process of globalization is one of the most critical developments affecting the evolution of national economies. Globalization offers participating countries new opportunities for accelerating growth and development but, at the same time, it also poses challenges to, and imposes constraints on policymakers in the management of national, regional and global economic systems. While the opportunities offered by globalization can be large, a question is often raised as to whether the actual distribution of gains is fair, in particular, whether the poor benefit less than proportionately from globalization—and could under some circumstances actually be hurt by it.

The risks and costs brought about by globalization can be significant for fragile developing economies and the world's poor. The downside of globalization is most vividly epitomized at times of periodical global financial and economic crises. The costs of the repeated crises associated with economic and financial globalization appear to have been borne overwhelmingly by the developing world, and often disproportionately so by the poor who are the most vulnerable. On the other hand, benefits from globalization in booming times are not necessarily shared widely and equally in the global community.

The fear that the poor have been by-passed or actually hurt by globalization was highlighted by the finding from a number of studies, emerging in the last half dozen years, which explicitly examined the trend of world income distribution as it evolved during the heyday of the globalization era. Many of these studies point towards an increasing inequality in the world income distribution and limited—if not a lack of—convergence among participating national economies and across regions as globalization has proceeded. Concern about inequality trends is relevant to the extent that the latter may affect growth and thereby poverty alleviation in the future. Inequality acts as a filter between growth and poverty.[1]

Inequality is also relevant to the measurement of poverty, if the *relative* definition of poverty is used rather than the *absolute* definition of poverty. While absolute poverty is defined in reference to a poverty line that has a fixed purchasing power determined so as to cover basic needs, relative poverty is determined as a fixed proportion of the mean income of population (Bourguignon 2004).

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1 Wealth (asset) inequality does matter for poverty outcome as much as income inequality. Since wealth and income tend to be correlated among individuals, these two types of inequality are clearly interrelated. Due to the paucity of data on asset distribution, however, most empirical studies are limited to and focus on income inequality.

Practically all estimates of poverty are based on absolute poverty rather than relative poverty lines. The most recent estimate based on household surveys (Chen and Ravallion 2004) suggests that if one uses a poverty line of PPP adjusted US$1 per day as a cutoff line, there were 390 million fewer people living in poverty in 2001 than in 1980. The number of poor fell from 1.5 billion in 1981 to 1.1 billion in 2001, and the share of the population of the developing countries living below US$1 per day declined from 40 per cent to 21 per cent. However, this study also shows that this progress on poverty reduction was mainly achieved by the substantial reduction of the poor in China (400 million fewer people were poor in China in 2001). Their estimate also indicates that the absolute number of the poor has fallen only in Asia and risen elsewhere and the total number of people living under US$2 per day actually increased worldwide. In particular, poverty has increased significantly in Africa in terms of poverty incidence as well as the depth of poverty.[2]

Though any trend in poverty and income inequality observed so far cannot be exclusively or even mainly attributed to the globalization effect as such, without rigorous analyses, these various estimates, even the most optimistic ones, cannot dismiss the concerns raised that the globalization process, as it has proceeded so far, may have had adverse effects on poverty and income distribution.[3] These concerns have generated a passionate debate worldwide as well as a powerful anti-globalization movement.

The extent of controversy surrounding this debate reflects the fact that globalization is not a process proceeding neutrally in a policy vacuum, but a policy-induced condition.[4] Globalization is not purely driven by new technological innovations and progress or by 'neutral' market forces and other inescapable sociopolitical forces, as often depicted in popular writings.[5] In particular, the contemporary phase of globalization is, to a certain extent, an outcome emerging from the global consolidation and diffusion of the economic policy paradigm, which emphasizes benefits and positive features of the liberalized policy regime. In this paradigm, trade and financial liberalization is seen, along other market-based institutional reforms such as privatization, legal and other regulatory systems, as the *sine qua non* of a successful integration into a globalizing world economy. This kind of position with a particular ideological stance might be questioned in the context of the fiercely

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2 See Wade (2002) and Deaton (2001, 2002) for critical discussions of the World Bank's estimates of global poverty and inequality used in these studies.

3 See also Culpeper (2002) for a recent critical literature review of the effect of globalization on inequality, in which a set of triangular relationships between globalization, growth and inequality is systematically discussed.

4 See Kozul-Wright and Rayment (2004) for an extensive discussion on this policy induced condition.

5 Helleiner (2001) emphasizes the need to distinguish two different phenomena associated with the term 'globalization'. Whilst the first is referred to as the shrinkage in space and in time that the world has experienced as a consequence of technological revolutions in transport, communications and information processing, the second usage points to policy choices and external liberalization involving political, economic and social choices. As he notes, despite this clear distinction, the recent association of external liberalization *policies* with the technology-driven *fact* of globalization has contributed to the terminological confusion.

contested debate on the appropriate roles of markets versus states. Indeed, in this regard, the recent discussion over the effects of globalization on poverty mirrors very much the earlier controversy over the appropriateness of structural adjustment programmes as a development strategy for low-income countries and the poor in particular.

Cornia (2000) argues, for example, that growing polarization among countries has been accompanied by a surge in inequality within most nations, where growth and poverty alleviation have suffered substantially. He suggests that the rising trend in inequality in recent decades cannot be explained by the 'traditional causes of inequality' (i.e., those responsible for income inequality in the 1950s-70s), which include high concentration of land and other assets, dominance of natural resources and associated rents, unequal access to education, and urban bias.

While noting that these traditional conditions remain important factors for cross-country differences in inequality, Cornia argues that the increased global inequality in recent decades is attributable more directly to the contemporary globalization effects, i.e., the nature of technological changes and policy reform measures such as frequent application of deflation policy under stabilization-cum-adjustment; trade liberalization; the rise of financial rents following financial liberalization and privatization; changes in labour institutions; and erosion of the redistributive role of the state.[6]

However, despite the utmost importance of understanding the globalization-poverty nexus, the precise nature of the various mechanisms, whereby the ongoing process of globalization has altered the pattern of income distribution and the conditions facing the world's poor is yet to be carefully analysed. As discussed below, the globalization-poverty relationship is complex and heterogeneous, involving multifaceted channels. It is highly probable that globalization-poverty relationships may be nonlinear in many aspects, involving several thresholds effects. Indeed, each subset of links embedded in the *globalization (openness)-growth-income distribution-poverty nexus* can be contentious and controversial. Besides the 'growth' effects of globalization on poverty (i.e., the effects of globalization on poverty filtered through economic growth), globalization/integration is known to directly create winners and losers, affecting both *vertical* and *horizonta*l inequalities (Ravallion 2004a). Because these multifaceted channels interact dynamically over space and time, the net effects of globalization on the poor can only be judged on the basis of 'context-specific' empirical studies.

While a number of studies have been conducted to investigate the globalization-poverty relationships through cross-country regressions, a deeper insight into this critical nexus cannot be obtained by regression studies alone, as it requires detailed empirical research in a country- and region-specific context.[7] Cross-country studies

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6 See Culpeper (2002) for further discussion of the effect of economic liberalization policies on income distribution and the poor.

7 See Reimer (2002) for a literature survey of the poverty impacts of trade liberalization in developing countries. In his survey, he classifies empirical studies into four methodological categories: cross-country regression, partial-equilibrium/cost of living analysis, general equilibrium simulation and micro-macro synthesis.

require precise measurements and definition of the two key concepts—globalization and poverty—and have been criticized on technical (econometric) grounds. Both concepts are multidimensional, and not easily captured in a composite index to be used in a meaningful manner in cross-country, comparative studies. Indeed, only detailed case studies are able to delineate the role of path dependence of multiple factors such as resource endowments, trade and production structures, policies, and institutions. Such research, if carefully conducted, should yield high dividends in identifying appropriate policy responses to globalization in relation to the overriding policy objective of poverty reduction.

This paper aims at providing a critical literature review of the debate surrounding the globalization-poverty nexus, focusing on channels and linkages through which globalization affects the poor. These various channels can be compared to rivers and canals flowing into a common sea or lake. Some of these rivers may be muddy and even polluted, others may be crystal clear. The resulting quality of the lake water depends on how these various flows combine. Similarly, with some stretch of the imagination, the ultimate net effects of the different globalization-poverty channels depend on their combined individual effects

The paper is structured as follows: In section 2, we first introduce four different concepts used to measure trends in world income inequality, which are relevant for our discussion on the globalization-poverty nexus. In section 3, we examine the 'growth' conduit through which globalization affects poverty, i.e. the growth channel. In section 4, we discuss other channels in the globalization-poverty nexus, operating through changes in relative factor and good prices, factor movements, the nature of technological change and diffusion, the impact of globalization on volatility and vulnerability, the worldwide flow of information, global disinflation, and institutions, respectively. Section 5 concludes with a discussion of strategic policy issues within the context of the globalization debate.

2 Concepts of world income inequality

An important issue that needs to be addressed at the outset, is what is meant by 'inequality' in the globalization debate. At least four different concepts (types) of income inequality can be identified.[8]

- The *first concept* measures differences in mean incomes between countries (or regions). There is no population weighting and every country counts the same. This concept is useful in determining the extent of convergence or divergence among countries or regions.

- The *second concept* takes mean national (or regional) incomes but weights them by the population of the countries (regions). In this case the resulting income distributions will be strongly affected by large countries (e.g., China and India) and regions.

8 The first three concepts listed here were defined by Milanovic (2004).

— The *third concept* measures interpersonal inequality at the global, national or regional level, respectively. At the global level, this concept yields the world's income distribution.

— A *fourth concept* is that of vertical and horizontal inequality. While vertical inequality refers to inequality among individuals at different levels of the income pyramid, horizontal inequality refers to inequality among individuals within the same broad income or socioeconomic class.

A crucial question is whether the worldwide income distribution has become more or less even during the recent globalization era. According to concept 1 (national GDPs per capita with each country weighed equally) there has been an almost continuous and sharply rising divergence over the last 50 years with the Gini coefficient rising from around 0.43 in 1950 to 0.53 in 2000. On the other hand, based on concept 2 (with each country's mean income weighed by population size), worldwide income distribution has become significantly more even with the qualification that this trend is totally driven by China. Hence, estimates of 'between-country' inequality vary widely, depending on whether estimation is made on the basis of using country-weights (concept 1) or population-weights (concept 2).[9] Note that both of these concepts ignore entirely the distribution of income within countries, as well as any change over time in those intracountry distributions.

The third concept captures inequality across individuals of the world as it includes the 'within-country' distributions. In this sense, it is the best measure of world income inequality and its evolution over time. The various attempts to measure this concept are in general agreement that worldwide inequality is very high and rose slightly up to the early nineties before falling marginally. The one exception is the study by Sala-i-Martin that appears to suffer from methodological flaws (Milanovic 2002a).[10]

While globalization could alter both vertical and horizontal inequality (concept 4), as Ravallion (2004a) argues, globalization may affect horizontal inequality particularly adversely by producing winners and losers among broadly similar groups. But clearly, class conflicts could result from vertical inequality. For example, a structural adjustment and trade liberalization programme could lead to higher food prices in a developing country, benefiting the farmers who are net sellers of food, while agricultural workers (the landless) who are net purchasers of food would be negatively affected by the reform.

Williamson (2002) and Bourguignon and Morrison (2002) observe that over the past two centuries, the diverging trend of world income has been mainly driven by the rise of between-country inequality rather than by the rise of within-country inequality.

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9 Estimates with country-weights take each country as one observation, while those with population weights give people equal weights. The merits and demerits of using either method are discussed in detail in Ravallion (2004). He favours some hybrid weighting scheme as the best way of analysing between-country inequality.

10 Sala-i-Martin uses national quintile distributions assuming no variance within quintiles and ignoring the increased income inequality in most of Eastern Europe after the fall of communism—among other arbitrary assumptions (Milanovic 2002a).

Since critics of globalization are often more concerned about the *policy* effects of globalization on the widening gap between rich countries and poor countries, greater attention in the debate has been given to the trend in the country-weighted between-country component of world inequality (concept 1). Indeed, according to this measure, between-country inequality has continued to increase over the last four decades, while within-country inequality has also steadily risen since the 1970s, reversing the early falling trend in the first half of the twentieth century. The convergence debate surrounding this concept of world inequality is discussed in section 5.

3 The growth channel in the openness-growth-inequality-poverty nexus

Policies of openness through liberalization of trade and investment regimes, and capital movements have been advocated worldwide for their growth and welfare-enhancing effects on the basis of the propositions embedded in the wellknown economic theories of international trade and investment (i.e. the Ricardian comparative advantage theory, the Heckscher-Ohlin-Samuelson model, the new trade theories à la Krugman, or the model of intertemporal international borrowing/lending or portfolio allocation models). In these models, the main growth-enhancing effects of openness are assumed to filter through: (i) static efficiency gains associated with improved resource allocation for national economies as well as for the world economy due to increased specialization; (ii) dynamic efficiency gains from such factors as economies of scale, diffusion of information, technology transfers, knowledge spillover effects as well as intertemporal trade gains from cross-border borrowing/lending for increased investment and consumption smoothing and portfolio risk diversification.

In order to analyse and understand the impact of openness on poverty, the causal chain *openness-growth-inequality-poverty* has to be scrutinized link by link.

3.1 The openness-growth link

The first link of the chain is from openness to growth. The main manifestation of openness is through trade and capital movement liberalization which in turn is presumed to affect growth directly through three subchannels: exports, imports and capital inflows. Trade liberalization policies encourage exports which benefit export industries and contribute to GDP growth. Although this link is relatively transparent, one issue still debated in the literature is the direction of causality. Do exports influence growth or does growth influence exports or are they interlinked into a virtuous circle? Using an instrumental approach, Frankel and Romer (1999) make a rather convincing case that trade influences growth both by increasing human and physical capital and by boosting total factor productivity growth.

A second subchannel links increased imports to growth. A country that switches from a regime of import substitution to one of trade liberalization will, in the short run, hurt the previously protected domestic industries, and suffer from a fall in fiscal revenues as a result of lower tariffs. However, the initial negative consequences on output are

likely to be more than compensated through a more efficient allocation of resources and benefits of competition, leading to a higher growth path. Successful cases of trade liberalization leading to growth are usually found when import liberalization is preceded by, or implemented in tandem with, export promotion policy and other measures to strengthen the technological capability of domestic producers, as was observed in the Asian NICs.

The third subchannel operates through the impact of foreign investment (FDI) and portfolio and other capital flows on domestic output and growth. If FDI takes the form of 'greenfield' investment as opposed to investment through merger and acquisition, much of the capital inflow from transnational corporations (TNCs) tends to be converted directly into factories producing new products. However, the transfer of technology, skills and management knowhow that is assumed to accompany FDI is not necessarily automatic or guaranteed. Further, the postulated positive effects of portfolio and other capital flows (hot money) on growth have been questioned increasingly in recent years. The recent IMF study (Prasad *et al.* 2003) acknowledges that it is difficult to establish a strong positive causal relationship between financial globalization and economic growth.[11] Furthermore these short-term capital flows contribute to the increased vulnerability to external shocks of the recipient developing countries.

A large number of empirical studies based on cross-country regressions have been conducted to show the beneficial effects of an open economy regime on growth, e.g., Dollar (1992); Sachs and Warner (1995); Dollar and Kraay (2001a, 2001b).[12] However, the validity of these empirical exercises has been contested on technical grounds by many researchers.[13] In a recent comprehensive critical analysis of the various studies on the relationship between trade and growth, Cline (2004: 248) concludes that 'overall it would seem that the weight of the empirical evidence is on the side of those who judge that more open trade policies lead to better growth performance'. It is worth noting here, however, that the positive openness-growth link is neither automatically guaranteed nor universally observable, as is discussed in detail in section 5.

3.2 The growth-inequality interrelationship

The second link in the causal chain from openness to poverty is the interrelationship between growth and inequality. There are two contradictory theoretical strands relating income- and wealth-inequality to growth. The classical approach best reflected by Kaldor argues that a higher marginal propensity among the rich to save than among the poor implies that a higher degree of initial income inequality will yield higher aggregate savings, capital accumulation and growth. Additional

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11 See Nissanke and Stein (2003) for a critical view on the effect of financial globalization on economic growth in emerging market economies.

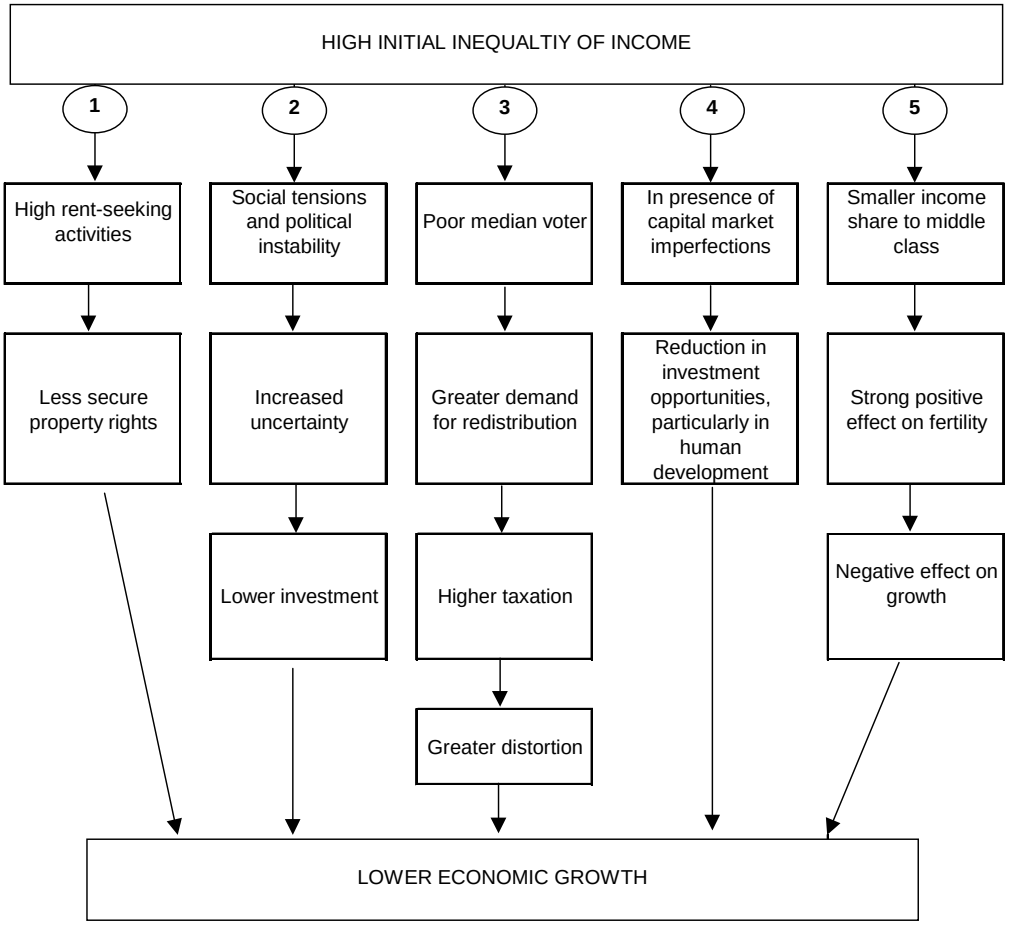
12 See World Bank (2002) for a summary of these cross-country studies on the openness-growth link.

13 See Rodriguez and Rodrik (1999) for an excellent critical assessment of these cross-sectional studies.

arguments in favour of the growth-enhancing effect of inequality are based on the existence of investment indivisibilities and incentive effects.

The contrasting new political economy theories linking greater inequality to reduced growth operate through a number of subchannels shown on Figure 1, which is adapted from Thorbecke and Charumilind (2002). These subchannels are, respectively: (i) unproductive rent-seeking activities that reduce the security of property; (ii) the diffusion of political and social instability leading to greater uncertainty and lower investment; (iii) redistributive policies encouraged by income inequality that impose disincentives on the rich to invest and accumulate resources; (iv) imperfect credit markets resulting in underinvestment by the poor, particularly in human capital; and (v) a relatively small income share accruing to the middle class—implying greater inequality—has a strong positive effect on fertility, and this, in turn, has a significant and negative impact on growth.

Figure 1
Channels through which inequality effects growth



Sources: (1) Benhabib and Rustichini (1991); Keefer and Knack (2000);
(2) Alesina and Perotti (1994);
(3) Alesina and Rodrik (1994); Bertola (1993); Persson and Tabellini (1991);
(4) Banerjee and Newman (1993); Aghion and Bolton (1997);
(5) Perotti (1996).

Some additional indirect paths (and more circuitous routes) through which inequality ultimately affects growth are likely to exist. Wide income and wealth disparities can impact on education, health and crime, respectively, through such manifestations as underinvestment in human capital, malnutrition leading to low worker productivity and stress and anxiety, respectively. In turn these manifestations may contribute to lower long-term growth.

The rejection of the Kuznets hypothesis of the inverted U-shaped relationship between growth and inequality (as per capita income increases) by a number of empirical studies provided much impetus to the new political economy literature (discussed above) that postulates that high initial inequality is detrimental to economic growth.[14] The proponents of this approach, while rejecting the immutability of the Kuznets curve, argue that growth patterns yielding more inequality in the income distribution would, in turn, engender lower future growth paths. Although country-specific evidence is quite limited and might not be generalizable to other settings, a recent study of the dynamics of inequality and growth in rural China based on the growth experience of villages finds a robust statistically significant evidence that inequality reduces growth (Benjamin, Brandt and Giles 2004). The authors suggest that the mechanism by which inequality exerts its negative effect was through its tilting of village economic activity away from higher growth nonagricultural development towards agriculture, thereby impeding structural transformation into nonagricultural activities.

In the light of the new literature that emphasizes the impact of inequality on incentives, social conflicts, transaction costs and property rights, the possible link between growth and poverty is examined in recent UNU-WIDER studies (Cornia 2000 and Addison and Cornia 2001). These studies argue that: (i) there is a concave relationship between inequality and growth: growth can be low at low levels of inequality due to disincentive effects and low at high levels of inequality through depressing effects on private investment caused by social conflicts; (ii) in this concave growth-inequality relationship, there exists a 'growth-invariant efficient inequality' range.[15] Given this growth-inequality relationship, these studies suggest that any country that intends to maximize poverty reduction should choose the lowest level of inequality within the broadly growth-invariant, efficient inequality range.

3.3 The inequality-poverty link via future growth

Since inequality is supposed to affect future growth and the future growth path, it also influences poverty. The UNU-WIDER volume cited above (Cornia 2004) concludes that the widespread increase in inequality has been detrimental to the objective of poverty reduction, because large rises in inequality have stifled growth, and because poverty, at any given growth rate of GDP, falls less rapidly in the case of a more unequal distribution than in the case of a more equitable one. Thus, in the analytical framework used to examine the inequality-growth-poverty relationship reviewed

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14 See Thorbecke and Charumilind (2002) for a comprehensive review of this new political economy literature on the subject.

15 For an illustration of this growth-inequality relationship, see Figure 2 in Addison and Cornia (2001)

above, the UNU-WIDER study clearly indicates that high inequality tends to reduce growth. The obvious policy implication following from the above causal sequence is that successful poverty alleviation depends not only on favourable changes in average GDP per capita growth but also on favourable changes in income inequality.

The conclusions drawn from the UNU-WIDER study challenge the dominant mainstream views derived from a number of World Bank studies such as Deininger and Squire (1996); Li, Squire and Zou (1998); Dollar and Kraay (2001a, 2001b). These conventional views argue that: (i) the 'within-country distributive impact' of globalization-cum-liberalization is on the whole neutral; (ii) the long-term distribution is broadly stable; (iii) there is no clear association between inequality and growth and growth is distribution neutral; hence growth is the only realistic option. For example, Dollar-Kraay (2002a, 2002b) argue that 'since the share of income going to the poor does not change *on average* with growth, the poor benefit from growth', and 'trade is good for growth and growth is good for the poor'.[16] They estimate that the *average* growth elasticity of poverty reduction ranges from 0.6 per cent to 3.5 per cent.[17]

However, the methodology used in yielding these results has since then been challenged. Ravallion (2002) argues, for example, that average neutrality found in the Dollar-Kraay study and other studies is not inconsistent with strong distributional effects at the country level. He concurs with Cornia's position, reaffirming that a critical question is whether or not inequality is an impediment to poverty-reducing growth, or in other words, whether high inequality attenuates the growth elasticity of poverty. His analysis confirms that the elasticity of poverty with respect to growth is found to decline with the extent of inequality.

There is probably no greater fundamental issue in economic development than a better understanding of the mechanisms through which growth affects poverty. Foster and Szekely capture the heart of the debate between two alternative approaches and models of development:

> one model emphasizes growth and efficiency under the idea that they eventually, if not immediately, improve the standard of living of the population at large, including the poor; the alternative model stresses that the state must play an active role in determining where the benefits of development end up, since it is not clear that the poor will benefit automatically (Foster and Szekely 2000: 59).

While it is axiomatic that growth is a necessary condition for poverty alleviation, the key questions are how the impact and the magnitude of growth on poverty reduction can actually be fully ascertained and measured; and what is the optimal degree of

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16 Dollar (2002) further reaffirms the strong positive causality from integration through growth to poverty reduction on the basis of the experiences of five countries (Bangladesh, India, Uganda, Vietnam and China) during the period 1992-98.

17 An early study by Ravallion and Chen (1997) estimates that based on a sample of developing countries, the growth elasticity of poverty on average, as measured by the headcount ratio (the proportion of people living below the conventional US$1 a day poverty line) is around 3. Bourguignon (2002) reports an average growth elasticity of poverty of 1.6.

active state intervention to reduce poverty without sacrificing (or with a minimum loss of) efficiency.

An inherent limitation of poverty measures is that they totally ignore the state of the income distribution above the poverty line.[18] An aggregate poverty measure is essentially a welfare function in which the poor receive all the weight and the non-poor receive no weight (Kakwani, Prakasah and Son 2000). Ideally, analysts would like to have access to a measure, spanning the whole income distribution, that combines poverty and inequality in a relatively non-arbitrary manner. Clearly, truncating income distribution at the poverty line is arbitrary and leads to a loss of information by failing to consider the distribution of income above the poverty line. Foster and Szekely (2000) quite cogently raise the question, 'Why should an income slightly higher (than the poverty line) be ignored, just because it is above the arbitrary cutoff being employed?'

They proceed to develop a methodology where the measurement of poverty is sensitive to the state of income distribution and includes a weighting scheme that is continuous in which the non-poor also receive positive weight which may be made as small as one wishes. It is based on Atkinson's (1970) family of 'equally distributed equivalent income' functions called *general means*. For different values of the parameter α, more weight is placed on higher incomes (for higher parameter values) and more weight on lower incomes (at lower parameter values). Based on 144 household surveys from 20 countries over the last 25 years, Foster and Szekely show that the growth elasticity of the general means can vary from 1.08 to a very low 0.22, depending on the choice of α. They conclude that:

> the positive value of the elasticity indicates that growth is good for the poor. However, it seems that it is even better for other sectors of society. This suggests a role for additional policies aimed specifically at guaranteeing that the poor share the benefits of development more proportionally (Foster and Szekely 2000: 69).

Indeed, despite the opposite inferences made by mainstream economists on the basis of cross-country regression analyses,[19] it has been increasingly recognized that the *pattern* of economic growth and development rather than the rate of growth *per se* may have significant effects on a country's income distribution and poverty profile. This issue has led to a debate on what constitutes pro-poor growth.[20]

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18 This and the following paragraphs are based on Thorbecke (2004).

19 While Berg and Kruger (2002) present a recent survey of mainstream literature on this topic, there have emerged many studies critical of the methodology used to establish these propositions (e.g., Galbraith and Kum 2002; Bourguignon 2002).

20 Culpeper (2002) notes, however, that the World Bank's strategy of 'pro-poor growth' usually consists simply of: (i) growth-oriented economic policies à la the Washington consensus; (ii) social investments in health and education; (iii) social safety nets that cannot take advantage of new opportunities created by economic growth. Indeed, these three components constitute the strategy adopted in the HIPC Initiatives so far.

3.4 Debate on pro-poor growth

DFID (2004) notes that there are two competing approaches to defining what constitutes pro-poor growth: an *absolute* and a *relative* concept. The *absolute* concept is associated with the work by Ravallion (2004b). Focusing on the rate of change in absolute poverty, he defines pro-poor growth as any growth in mean income that benefits the poor in absolute terms. According to this definition, any increase in GDP that reduces poverty measured by some agreed indicators is pro-poor growth, even if it is accompanied by a worsening income distribution. In contrast, the relative concept places much more emphasis on the distributional effect of growth, i.e. changes in inequality during the growth process. For example, Kakwani and Pernia (2000) consider growth as pro-poor if the distributional shifts accompanying growth favour the poor proportionately more than the non-poor.

As Osmani (2004) notes, what matters most for the relative concept is the nature and pattern of growth, whereas the absolute concept captures the effect of the totality of the growth process on poverty. Seen in this light, both concepts are useful for policymakers in tackling the issue of poverty reduction, although it is difficult for some analysts to *accept* as pro-poor growth a situation where, for example a 10 per cent aggregate GDP growth rate would reduce the incidence of poverty by only 1 per cent.[21] Recognizing this point, Kakwani, Khandker and Son (2004) propose a better measure of pro-poor growth, using the concept of the 'poverty equivalent growth rate (PEGR)' which takes into account both the magnitude of growth and how the benefits of growth are distributed to the poor and the non-poor.[22]

Indeed, the debate on the meaning of pro-poor growth is related to the issue underlining the complex triangular relationships among poverty, growth and inequality, as discussed above. Taking up this relationship, Bourguignon (2002 and 2004) notes that first, absolute poverty reduction could be achieved through two effects: (i) the growth effect, i.e. the effect of the growth rate of the mean income of the population; and (ii) the distribution effect, i.e., the change in the income distribution. Second, he emphasizes that these two effects are not independent of each other, but dynamically interact over time in a country-specific context, producing heterogeneity and nonlinearity in the poverty-growth relationship. More specifically, both the growth-elasticity and the inequality-elasticity of poverty are increasing functions of the level of development and decreasing functions of the degree of relative income inequality.

Hence, Bourguignon (2004) advances the following three interrelated points:

i) Distribution matters for poverty reduction;

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21 It is important to note here that irrespective of which concept is used in discussing pro-poor growth, what is considered *pro-poor* critically depends on the choice of standards for poverty measurement, in particular, the shape of the distribution around the poverty line and the choice of poverty lines (Grinspun 2004).

22 If PEGR is larger than the actual growth rate, which occurs when the incomes of the poor grow more than the average income, then growth is pro-poor; if PEGR is equal or less than the actual growth rate, growth is said not to be pro-poor.

ii) Effective redistributive policies may in fact yield a double dividend: they reduce poverty today and accelerate poverty reduction in future, as discussed above;

iii) The real challenge in establishing a development strategy for reducing poverty lies in understanding the interactions between distribution and growth.

Thus, despite the heated debate concerning the definition of pro-poor growth, there appears to be general agreement that poverty reduction would require some combination of higher growth and a more pro-poor distribution of the gains from growth. For Ravallion (2004c), the real issue is not *whether* growth is pro-poor, but *how* pro-poor it is, which can be measured by a 'distribution-corrected' rate of growth. Referring to the growth-distribution relationship, Ravallion (2004c) supports the points made by Bourguignon above by arguing that 'while there may well be tradeoffs between what is good for growth and good for distribution, but some factors that impede growth may also prevent the poor from fully sharing in the opportunities unleashed by growth'.[23] From this perspective, one could reach a general definition acceptable to both sides of the debate, i.e. growth is considered pro-poor if it, in addition to reducing poverty, also decreases inequality.

Now, from a policy perspective, it is important to note that pro-poor growth cannot be achieved spontaneously. There is increasing recognition that the postulated 'trickle down' *process* often fails to materialize or is too slow to have a significant impact. Hence, pro-poor growth requires strong commitments on the part of policymakers to adopt pro-poor policies capable of producing and sustaining a distribution-corrected growth path. The exact design of such pro-poor policies depends on initial conditions and institutions in country-specific settings.

4 Other channels in the globalization-inequality-poverty nexus

Aside from the *growth* channel discussed above, there are *various other* channels, through which globalization can produce winners and losers, and hence impact upon poverty. The globalization channels we examine here are:

- Changes in relative product and factor prices;
- Differential cross-border factor mobility and associated changes in global market and power structures;
- The nature of technical progress and the technological diffusion process;
- The impact of globalization on volatility and vulnerability;
- The impact of globalization on the flow of information;
- Globalization and global disinflation; and

23 See Lopez (2004) for the debate on the trade-offs between pro-growth and pro-poor policies.

— Institutions in developed and developing countries that mediate the various channels and transmission mechanisms linking globalization to poverty.

4.1 Changes in relative prices of factors and products

The income distribution effects induced by a shift in relative product prices in the process of *the* opening up of trade are well-known, as postulated in the Samuelson-Stolper theorem of international trade theory. The losers (especially the poor residing in either urban or rural area) may be vulnerable to these induced effects in addition to changes in absolute and relative prices of wage goods (Williamson 2002). Thus, globalization can affect poverty directly through relative price changes in factor markets and goods markets.

According to the Stolper-Samuelson theorem as applied to the within-country inequality, developing countries well-endowed with unskilled labour should experience a decline in income inequality through an increased demand for unskilled labour, while unskilled labour in developed countries would lose out with an adverse effect on equity.[24] Rodrik (1997) confirms this income distribution effect for industrialized countries in terms of a more elastic demand for unskilled domestic labour in the presence of a large international pool of unskilled labour. However, the postulated narrowing wage gaps between skilled and unskilled labour have not been observed in many developing countries, particularly in Latin America and Africa.

Kanbur (1998) explains this disconnect between what theory predicts and the actual outcome in terms of segmented factor markets and the time horizon of the analysis, suggesting that the benign income distribution effects would eventually materialize on the strength of long-run factor mobility.[25] Wood (1999) proposes two possible explanations for the increased wage disparity in Latin America: (i) the entry into the world markets in recent decades of low-income Asian economies, such as China and India, with abundant reserves of unskilled labour; and (ii) the nature of new technology heavily biased in favour of skilled and educated labour.[26]

4.2 Factor mobility

Globalization winners and losers can be produced through channels other than changes in relative product and factor prices which are a main conduit for the income-distribution effect of trade openness in the Heckscher-Ohlin-Samuelson-Stolper (HOSS) model. For example, unlike in the HOSS world which assumes factor

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24 As Culpeper (2002) notes, international trade theories also predict a similar effect of factor mobility on inequality. Thus, in theory, we predict that globalization would increase inequality within developed countries, but decrease inequality within developing countries.

25 Many mainstream economists argue that higher unemployment and greater poverty observed following trade openness are the direct results of pervasive labour market 'distortions' such as minimum wage legislation or imperfect labour mobility across sectors induced by these distortions.

26 Culpeper (2002) notes that technology can be either exogenous (and biased towards factors such as capital or skilled labour) or endogenous and responsive to relative factor-abundance.

mobility only within a country, cross-border factor mobility has historically been a dominant force in the globalization process for many centuries. The highly differentiated degree of cross-border factor mobility observed today may be identified as another channel of producing winners and losers as a result of globalization.

In this context, it is of interest to note that income convergence among the globalizing countries during the first wave of modern globalization between 1870 and 1914 was driven primarily by migration. Sixty million people, including largely unskilled workers, migrated from Europe to North America and other parts of the new world during that period (Williamson 2002 and World Bank 2002). In contrast, in the current phase of globalization, the extent of cross-border mobility differs significantly between skilled and unskilled labour. In consequence, as noted by Faini (2001), the 'wage equalization' theorem postulated by the international trade theory is less likely to take place through labour migration.

Furthermore, according to theory, capital seeking higher returns should move to capital-scarce developing countries, thereby raising the marginal productivity and labour wages in these countries (Easterly 2004). However, in reality capital does not flow to developing countries to finance productive investment as much as predicted (known as the Lucas paradox). International capital markets in recent decades have not acted as an intermediation function between saving supply and investment demand on a global scale. Rather, as Obstfeld and Taylor observe

> today's foreign asset distribution is much more about asset swapping by rich countries—diversification—than it is about the accumulation of large one-way positions—a critical component of the development process in poorer countries in the standard textbook treatments. It is more about hedging and risk sharing than it is about long-term finance… (Obstfeld and Taylor 2001: 64).

Indeed, the large discrepancies between *gross* capital flows and *net* capital flows reflected in countries' current account positions point to the condition where *diversification* finance far overwhelms *development* finance in cross-border capital transactions.[27]

More generally, Culpeper (2002) summarizes several distinctive features of factor movements in the current wave of globalization: (i) capital and skilled labour do not migrate to poor countries as much as among developed countries; (ii) there is a tendency for skilled labour to migrate from developing countries to developed countries; (iii) with capital market liberalization, there is a propensity of capital flight to developed countries, particularly during periods of crisis or instability. With such 'perverse' movements, he points to the possibility that as globalization proceeds, developed countries would see inequality fall, while developing countries would experience rising inequality.

We can indeed expect greater global integration to affect internationally mobile factors (skilled labour and capital) differently from those factors that are not—or

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27 See Nissanke and Stein (2003) for more discussion on the nature of financial globalization.

less—mobile (unskilled labour and land) in both developed and developing countries (Rodrik 1997 and Kanbur 1998). In this context, Basu (2003) explains why unskilled labour is additionally disadvantaged in the current phase of globalization. He argues that while the mobility of unskilled labour is severely restricted and regulated, *de facto* labour mobility has taken place through the increasingly free cross-border capital mobility and TNCs' ability to relocate production sites in response to changes in relative labour costs. In fear of driving away TNCs, governments of developing countries are less likely to enact regulations to protect and enhance labour rights.[28] Thus as observed over recent decades, the differential factor mobility may profoundly affect the functional income distribution between labour and capital.

4.3 Technological progress and technological diffusion

The nature of technical progress and of the technological diffusion process can be a further channel through which globalization could affect income distribution and poverty. Culpeper (2002) suggests that technical change emanates predominantly from R&D activities in the developed (industrialized) countries in response to conditions typical of their own resource endowment. Hence, technical change tends to be labour-saving and skill-biased, and would tend to increase inequalities universally in both developed and developing countries.

Referring to the importance of distinguishing between three categories of labour (skilled, semi-skilled and unskilled labour), Milanovic (2002b) also explains the increased wage inequality in low-income countries with the situation in which increased globalization, through trade and FDI, has raised the demand for semi-skilled labour but not for unskilled labour, as a minimum skill level is required for production. Hence, it is the skilled or semi-skilled labour that benefits from globalization, while unskilled labour has been increasingly marginalized by it.

Similarly, Kanbur (1998) adds the technology factor as an explanation for the observed increase in skilled-unskilled wage differentials in many developing countries, in particular when capital inflow embodying new technology is complementary to skilled labour. Thus, he argues that greater openness and integration into the world economy will have the benefit of providing access to more productive technology, but will widen the gap between skilled and unskilled wages in the modern sector and in the economy as a whole. Agénor (2002) also notes that the wage disparity widens after trade liberalization and the associated decline in the cost of imported technology and capital goods, because there is a high degree of substitutability between unskilled labour and capital, in contrast to the high degree of complementarity between skilled labour and capital.

Furthermore, technological diffusion and access to new technology is not universal and spontaneous. Hence, global productivity differences may widen over time, which

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[28] Basu (2003) also notes that due to this *de facto* labour mobility, labour market policies of developing nations have become a matter of major concern in international fora and organizations because working conditions in developing countries have effects on employment conditions in industrialized nations. Thus, with globalization, he argues, there is a need for international labour standards, set preferably by the ILO.

may increase income inequality. For example, Easterly (2004) argues that in addition to differences in factor endowments, productivity differences between countries have driven trade and factor flows, and income inequality.[29] Indeed, the technological gaps between innovating and imitating countries as discussed in Vernon's product cycle model are still a dominant factor in determining global inequality between countries in income and wages.

Arguably, globalization has accelerated the process of privatization, including the privatization of research. Nowhere is this trend clearer than in agriculture. The green revolution, which was in the public domain, has been replaced by the biotechnological revolution which is very much in the private domain. The latter is led by TNCs expecting royalty payments for their new products, largely genetically modified (GM) seeds.[30] A potential issue is whether small farmers in developing countries (e.g., in Sub-Saharan Africa and South Asia) can actually afford to adopt biotechnology and if not, what are the consequences for income distribution and poverty. While it is probably too early to judge, it has been argued that the concern that risk-averse poor farmers cannot afford to purchase the costlier GM seeds does not seem to be vindicated by the dramatic takeup of GM cotton in developing countries as soon as it is available and seen to be profitable.[31]

4.4 Volatility and vulnerability

Greater openness tends to be associated with greater volatility and economic shocks, which affect more severely the vulnerable and poor households, and deepen poverty and income inequality (Culpeper 2002). Goldberg and Pavcnik (2004) also emphasize the effect of trade liberalization on inequality because of the increasing vulnerability of unskilled labour through several 'labour market' channels. Birdsall (2002) reports growing empirical evidence of validating the claim that the poor are hurt disproportionately more during contractionary periods than they benefit from expansionary periods. Similarly, on the basis of a very extensive survey of the empirical literature, Winters, McCulloch and McKay (2004) conclude that while the empirical evidence broadly supports the theoretical proposition that whilst trade liberalization will be poverty-alleviating in the long run and on average, it also necessarily brings about distributional changes. They point to a lot of evidence that

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29 Relative cost advantages arising from technology differences are the basis of understanding the trade *patterns and* aggregate gains from trade in classical Recardian trade theory. Easterly (2004) extends this theory to explain the observed income inequality as globalization proceeds. For the contemporary version of the Ricardian trade model and possible effects of technological innovation in China on global trade flows, see Samuelson (2004).

30 Concerns and anxieties have been raised about the effect of GM seeds on health, environment, and other conditions affecting our life in the long run. Here, we do not take a particular position in this controversy, stating that it may still be too early to pass definitive judgement .

31 On the adoption experience in China and India, for example, see Pray *et al.* (2003).

poorer households may be less able than richer ones to protect themselves against (short-term) adverse effects, or take advantage of trade liberalization.[32]

The Asian financial crisis demonstrated unambiguously the high price poor households had to pay during the downturn. Massive capital outflows during the crisis combined with tight monetary and fiscal policies mandated by the IMF, led to wide currency fluctuations (at one time, the Indonesian rupiah depreciated by 500 per cent) and a liquidity crisis that reduced output and employment. Poor households in the urban areas, lacking safety nets, suffered disproportionately during the transition period before these economies recovered.

Interestingly, there is some evidence that volatility is negatively correlated with growth in developing countries in contrast with developed countries where this correlation is positive (Kose, Prasad and Terrones 2004). An implication of this finding is that poor countries growing slowly are further burdened by greater volatility.

4.5 Flow of information

Globalization has contributed to the enormous increase in the flow of information and knowledge worldwide. Internet technology and the spread of mass media transmit information almost instantaneously. Clearly, this provides enormous potential to contribute to the human and technical capital of households in the third world. At this stage, an important issue is the design and development of channels through which this flow of information is made accessible to poor households in useful form.

Notwithstanding the major contribution this flow of information can make to speed up the development process, there are some downsides. Graham (2004) has argued that the increasing flow of information about the living standards of others can result in changing reference norms and increased frustration with relative income differences, as members of a given socioeconomic or occupational group in a poor country can increasingly compare their welfare with similar groups in richer countries.

Globalization can also increase volatility and insecurity for many cohorts, particularly those (such as older people) not well positioned to take advantage of the new opportunities offered by the opening up of trade and capital movements.

4.6 Globalization and global disinflation

In the last decade, global inflation has dropped from 30 per cent per year to 4 per cent. Rogoff (2003) attributes this to a number of factors such as improved central bank institutions and practices, improved fiscal policy, and the technological revolution. However he emphasizes the role played by the increased level of competition, in both

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[32] Winters, McCulloch and McKay (2004) stress that there can be no simple general conclusion about the relationship between trade liberalization and poverty and the impact of trade liberalization on poverty. The outcome is very much context-specific, dependent on the environment in which it is carried out, including the policy design and implementation.

product and labour markets, that has resulted from the interaction between increased globalization, deregulation, and a decreased role for governments in many economies.

It would be difficult to argue that this dramatic disinflation channel does not have beneficial effects on the poor worldwide. Even the small subsistence farmers who tend to be relatively sealed off from the market economy must enjoy certain advantages in terms of lower prices for their consumption goods. However, a question to be raised is whether the overemphasis on macrostability in some developing countries might not have been at the expense of some additional growth.

4.7 Institutions

Institutions mediate the various channels and mechanisms through which the globalization process affects poverty (Sindzingre 2004). Institutions act as a filter intensifying or hindering the positive and negative pass-through between globalization and poverty, and can help explain the diversity, heterogeneity and non-linearity of outcomes. This filtering process operates at the multi-country, country and even village level, respectively. International institutions such as the IMF and WTO follow their own rules of the game, having often a major impact on poverty outcomes. Likewise, institutions that protect agricultural commodities in the developed countries can block the channel of exports for the same commodities from the poorest countries (largely in Sub-Saharan Africa), thereby preventing them from harvesting the benefits of trade openness. At the other extreme there are examples of village-level institutions that can protect resident households from environmental degradation and subsequent poverty caused by overexploitation of resources (such as forest resources) by TNCs.

Rodrik (1998a and 1998b) argues cogently that the benefits of trade openness can be reaped fully only in countries with effective institutions, in particular institutions that can successfully resolve the distributional conflicts stemming from trade openness. He also highlights the primacy of institutions over geography and integration in explaining comparative economic development experiences (Rodrik 2004 and 2005).

Indeed, once institutions are defined broadly *à la* North as 'the humanly devised constraints that shape human interaction', institutional environments are important in determining whether the benefits of globalization are harnessed and spread positively and evenly, and negative shocks associated with globalization are filtered out through safety nets. As Sindzingre (2004) argues, for example, the impact of globalization on the poor is intermediated on the one hand by domestic political economy structures and institutions such as social polarization, oligarchic structures, and predatory regimes that may bias, confiscate or nullify globalization gains for particular groups of poor. On the other hand, the positive effects of globalization on growth and poverty can be found when institutional conditions are characterized by such elements as political participation, social cohesion and management of social conflict arising directly from globalization effects.

At the same time, globalization can bring about changes in institutional environments. For example, as globalization proceeds, there may emerge a new set of norms and conventions, as well as new standards of transparency, accountability and

enforcement of law and accommodation of human rights and civil movements.[33] Yet, traditional institutions may erode under the pressure of market integration. For example, customary land tenure may lose its social security and equity functions through the individualization of land rights and land concentration stemming from market transactions, especially when combined with demographic pressure. More generally, however, institutional changes can be slow and changes tend to work at the margin, since 'institutional change is incremental as a result of the imbededness of informal constraints in societies' (North 1990: 6).

5 Empirical evidence and policy debate in the globalization-inequality-poverty nexus

5.1 The convergence debate and the importance of strategic integration

The observed between-country income divergence trend (discussed in section 2) tends to bring into question the validity of the income *convergence* thesis, advanced by Sachs and Warner (1995) and others. The thesis postulates that adoption of open trade regimes by the poorer economies would lead to a *convergence* of their incomes towards those of the richer nations in the process of globalization. Krugman and Venables (1995) also support the convergence thesis, by constructing a model of the globalizing world economy. In the latter model, the income levels of countries in the core and the periphery would converge in the long-run after an initial period of divergence, as trade/transport costs decline over time. Their convergence-time profile is essentially driven by the presence of economies of scale and agglomeration effects in the initial period, and factor-mobility and relocation of production in the subsequent period. The latter course is assumed to take place as a result of multinational firms responding to continuous shifts in comparative advantages among nations and regions.

It is, however, abundantly clear that the mere adoption of open trade and investment regimes does not guarantee entry of the developing countries into the convergence club. Dowrick and DeLong (2001) suggest that (i) openness to the world economy does not necessarily promote convergence; (ii) many poor countries that have opened their economies since the 1980s have fallen behind, not just relatively but absolutely in terms of both income levels and structural development.

In this context, it is pertinent to refer to the analysis by Kitson and Michie (1995), which argues that:

> the benefits of trade do not evenly spread globally and trade may indeed lead to persistent divergence in growth, as it could influence economic growth through the *twin* processes depending on the initial conditions of trading countries; virtuous cycles of trade-induced growth for stronger nations and

[33] However, Sindzingre (2004) suggests that globalization as a set of flows and policies is more likely to induce transformation on the aspects of institutions that are already experiencing rapid change, e.g., formal political or economic rules, and less likely to affect slow-changing institutions such as social norms.

> vicious cycles of trade-induced decline for weaker nations (Kitson and Michie 1995: 5).

A similar point is made by Kozul-Wright and Rayment (2004: 4), who argue that 'moves towards a more open and integrated economic space are just likely to reinforce as they are to diminish the gaps between developed and developing countries'. They suggest that since economies are subject to processes of cumulative and circular causation, whether global market forces establish a virtuous circle or vicious circle will depend on the initial conditions at the time of exposure and the effective design and implementation of policy to manage the integration process.

Incidentally, it is relevant to note that 'non-convergence' can also be observed at the interregional level. China is a prime example of a country in which regional inequalities increased dramatically under the influence of the globalization process that brought about large flows of FDI to the coastal provinces but largely by-passing the inland provinces.

Non-convergence and modes of integration

Indeed, the conundrum of the persistent 'non-convergence' of world income should be explicitly addressed in terms of structural features of the global economic relationships as they evolved over time and the institutional conditions found in participating countries.[34] The income convergence trend among nation-states, to the extent that it has been observed historically, is likely to be explained more effectively by the nature of integration and specialization of sub-groups of countries, rather than by the degree of openness of the trade and investment regimes *per se*, as is often claimed. In particular, in the current phase of globalization, developing countries have to reach a certain threshold, by undergoing substantial changes in trade and production structure, before they experience income convergence. As the World Bank study acknowledges:

> successful globalizers' are those developing countries, which have managed to break into global markets for manufactures and services, and reduce inequality in this process. It recognizes that for many low-income countries and poor people, 'globalization is not working' (World Bank 2002: 2).

Clearly, countries need to have reached the takeoff point before they can take advantage of the potential benefits of openness and globalization.

One of the critical reasons why globalization may not be working for low-income developing countries lies in the fact that the effects of international trade on growth are critically dependent on the pattern of specialization and integration. By treating two sectors symmetrically, the conventional Heckscher-Ohlin trade model (consisting of two countries, two sectors and two factors) shows that two countries equally reap

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34 See Rodrik (2002, 2004, and 2005) for the debate on the role of developmental state and institutions in this particular conjuncture.

aggregate gains from trade through efficiency gains.[35] In reality, however, the pattern of specialization does matter for welfare implications of a trade-induced growth path on at least two accounts.

Two sectors need not be symmetrical, first, through the well-known immiserizing effect of trade *à la* Bhagwati, i.e. the terms-of-trade (TOT) effects. Though many dismiss the likelihood of such an effect in a small economy, low-income countries dependent on the exports of a limited range of primary commodities face a deterioration of TOT, in particular if the 'fallacy composition effect' is seriously taken into account. In the 1980s and 1990s, many primary commodity exporting countries, which implemented structural adjustment programmes, underwent simultaneous export drives, leading to depressed prices in many export commodities (Nissanke and Ferrarini 2001). In this context, Birdsall (2002) draws attention to the fact that measured by the trade-GDP ratio or tariff rates, most commodity-dependent countries have not been more reticent than least commodity-dependent countries about participating in international trade, but the former group has failed to grow (especially after 1980), as they have remained dependent on exports of primary commodities.

Furthermore, two sectors are not necessarily symmetrical on account of dynamic scale economies, i.e. dynamic externalities through technological spill-over benefits and the accumulation of knowledge capital. As the endogenous growth theory emphasizes, it is this factor that largely accounts for diverging growth rates among countries. An application of this phenomenon to the trade model implies that a country specializing in an industry with a larger positive externality would experience a faster growth rate compared with the trading partner that specializes in an industry with a weaker externality. Thus, the growth rate of the two trading countries could differ considerably, depending on the pattern of specialization.

If a country follows the Rybczinski line dictated by static comparative advantage with given relative resource endowments, the country with an initial comparative advantage in 'non-dynamic' sectors may end up in a low equilibrium trap. Countries that have benefited from globalization and integration—such as those found in East Asia—are the ones which have successfully completed the structural transformation of the composition of their production and trade structure with continuous upgrading of their human skill endowments and technology/knowledge base. Consequently, their comparative advantages have evolved over time to maximize the benefit from dynamic externalities.

Seen from this perspective, openness *per se* is not sufficient to insure that development will follow. The internal pattern of growth and forms of integration are critical for countries to benefit from globalization-induced growth. It is in this conjuncture that the *polarization* thesis or the *international poverty trap* thesis, advanced by UNCTAD (2002), can be evaluated. The UNCTAD thesis suggests that: (i) there is a close association between the incidence of poverty and dependence on

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35 This two-sector model of international trade can be easily extended to N-sector model (for example, see Dornbusch, Fisher and Samuelson 1977).

exports of primary commodities;[36] (ii) this explains the increased poverty and the socioeconomic marginalization in the commodity-dependent poorest countries, where an interrelated complex relationship between international trade and finance is reinforcing the cycle of generalized poverty and economic stagnation; (iii) the current form of globalization is tightening—not loosening—this international poverty trap.[37] Indeed, the polarization thesis reminds us of the importance of reaching the *takeoff stage* before countries can benefit from globalization, as discussed.

Strategic integration into the world economy

One of the critical issues facing policymakers in low-income developing countries in formulating their strategic position towards the globalization process is how to evolve their patterns of comparative advantage over time. A strategic position towards globalization cannot be equated with a simple fine-tuning of the pace and sequence of liberalization measures. Clearly, it is a question concerning the pattern or forms of integration. In particular, national development policies should be strategically designed in the light of the skewed nature of the on-going process of globalization.

First, dynamic externalities and rent-rich activities are increasingly concentrated in high-skill, knowledge-intensive sectors. In short, the skill- and technology-related divide has become wider over recent decades. This trend is reflected in the continuously declining terms of trade of less skill-intensive manufactured goods relative to high-skill and technology intensive goods (Maizels 1998; Wood 1997). Kozul-Wright and Rayment (2004) note that the markets for many labour-intensive products, consisting increasingly of internationally standard goods, have come to resemble those for primary products.

Second, trade in the current phase of globalization is largely mediated through international production with an increasing share of intra-firm trade undertaken by TNCs, which command a lion share of global production and marketing networks. Considerable asymmetries in market power and access to information, technology and other intangible knowledge assets between TNCs on the one hand and local farmers and traders in developing countries on the other hand have resulted in a hugely skewed distribution of gains from trade. This is reflected in the TNCs' dominance in commodity and value chains of international traded goods, as well as in frequently observed conditions such as the sharp decline in real wages in export processing zones (Kaplinsky 2002). The benefits of productivity improvements, instead of going to the fragmented producers and farmers, are largely appropriated by the TNCs and

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36 UNCTAD (2002, 2004) suggests a very close association between the 'commodity trap' and the 'poverty trap' (UNCTAD 2004: 46).

37 Defining a poverty trap as a situation in which poverty has effects that act as the causes of poverty, Gore (2003) suggests that poverty traps exist at different levels of aggregation: at the micro (household and community) level, the national level and global level. At the global level, a country can get stuck in an international poverty trap, where the nature of the international economy and institutional structures that govern international relationships are implicated in the processes of circular causation of persistent poverty at the household, community and national levels.

global supermarket chains that can exploit oligopolistic commodity markets at later stages of the value chain (UNCTAD 2004).[38]

This uneven distribution of market power points to the need to improve the negotiating positions of developing-country governments vis-à-vis TNCs. Kozul-Wright and Rayment (2004) emphasize the desirability of adopting policies to guide FDI within a national development strategy. In this context, Lall (2002) argues for a strategic, targeted approach to FDI, so that FDI could facilitate skill- and technology-transfer and generate strong positive productivity spillovers for domestic firms.

Given the observed trends towards inequality both globally and within many nations, in order to derive benefits from globalization's dynamic forces, developing countries have to take strategic steps to protect themselves with a long-term vision for upgrading their comparative advantages towards high-value added activities by climbing the technology ladder. This can be realised by developing technological capabilities through learning and adaptation. To succeed, developing-country governments should consciously engage in building institutional capacities for integration, including a capable nation-state that is ready to take on the enormous challenges posed by globalization.

5.2 The importance of structural transformation

Threshold effects of globalization

Now, we turn to the impact of globalization on income distribution and poverty incidence *within* countries. Milanovic's (2002b) cross-country econometric analysis, based on household survey data in 1988 and 1993, suggests that openness worsens individual countries' income distribution before improving it, and that the effect of openness on income distribution depends on the country's initial income level. In his view, this is conditioned by the fact that 'openness helps those with basic and high education, but reduces the income share of those with no education' and 'it is only when basic education becomes the norm even for the poor that openness exert an income equalizing effect'. Thus, Milanovic postulates that 'openness helps income distribution chart an inverted U-shaped curve as the income level increases. At low income levels, openness is bad for equality: at medium and high income level, it promotes equality' (Milanovic 2002b: 13).[39]

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38 UNCTAD (2004) reports that the value of global retail sales of coffee today is about US$70 billion, of which producers receive only US$5.5 billion.

39 Easterly (2003) also advances the hypothesis of an inverted U-shaped relationship between inequality and openness, measured as (*Exports* + *Imports*)/GDP), which would drive out the usual Kuznetz curve between income and inequality, typically found in cross-country empirical studies. However, he explains this in terms of the cross-country difference in factor endowments and the trade openness: less open economies tend to export mainly natural resource-based commodities that are associated with inequality, whilst open economies export labour-intensive manufactures and services, whereby inequality diminishes. However, as he admits, his hypothesis is based on a casual observation rather than a rigorous analysis.

Further, Agénor (2002) discusses a similar inverted U-shape relationship between globalization and poverty operating through a 'relative wage effect'. Referring to the close substitution between imported capital goods and unskilled labour, he reckons that the skilled-unskilled wage gap increases initially as a consequence of trade liberalization.[40] However, he argues that this initial widening in wage differentials may lead to investment in human capital, a gradual increase in the supply of skilled labour, and a narrowing wage gap over time. Thus, he suggests that there exists a non-linear Laffer-type relationship between poverty and globalization: at low degrees of globalization, globalization does hurt the poor while at higher levels, it leads to a decline in poverty. From this perspective, he infers that globalization may hurt the poor in some countries not because it went too far but rather because it did not go far enough.

Thus, these studies suggest there may be critical *thresholds* that must be reached before globalization can make a positive contribution to poverty reduction. The non-linear relationship between globalization and poverty postulated in these studies is interesting and worth further investigation. However, policy implications from these studies should be drawn very carefully. For example, Agénor's reasoning behind his policy conclusion is based on the assumption that investment in human capital would somehow increase automatically with the widening wage differentials across skills. Even if such an investment in human capital were to occur, it could take a long time before low-income countries would experience a significant reduction in poverty. Hence, sizeable public investment in skill upgrading is likely to be a key for ensuring such results. Meanwhile, in countries at an early stage of development, i.e. those that have not reached the critical threshold, the poor should be protected from negative effects of globalization through various institutions of social protection and redistributional policies.

Structural transformation of an agrarian economy

Furthermore, it is important to recognize that in a world of interdependent evolution, openness is a necessary but insufficient condition for development to succeed. All countries have to undergo structural transformation throughout the process of development. At the outset of the development process a country is predominantly agrarian and the economy relatively closed. The majority of output originates in agriculture where the bulk of the labour force is employed. A key issue in triggering the cumulative growth process at the early phase of development is generating the resources required to reach the takeoff point.

Long before most other developing countries, the East Asian governments understood that the major mechanism for obtaining the resources needed for escaping the poverty trap and for industrialization was through an intersectoral transfer from agriculture. The role of the agricultural sector was to generate a surplus that could finance the

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40 In addition, Agénor (2002) refers to a separate output effect, through which trade liberalization may have an inverted J-curve effect on poverty. This is because trade liberalization produces at first a decline in output and income due to a contraction in import competing industries, which could lead to an increase in poverty. However, such a decline is seen as temporary, as output is assumed to increase over time with an expansion of exports, which could attenuate poverty.

necessary physical infrastructure and pragmatically educated labour force for the industrialization process to succeed.

A lesson learned from the countries that were most successful in achieving both growth and equity throughout their development history (e.g., Taiwan and South Korea) is that a continuing *gross* flow of resources should be provided to agriculture—irrigation, inputs, research and credit—combined with appropriate institutions and price policies to increase this sector's productivity and potential capacity of contributing an even larger flow to the rest of the economy and hence a *net* surplus. Exploiting the agricultural sector too early in the development process—so typical in Sub-Saharan African and some Latin American countries—short-circuits the structural transformation. In short, reaching the takeoff point is a precondition to embarking on the next phase of development (industrialization) and taking advantage of the potential benefits of openness (Thorbecke and Morrisson 1989).

The fundamental role of agriculture in reducing poverty has been highlighted within the context of China by Ravallion and Chen (2004). They show that the bulk of the dramatic poverty alleviation in China occurred before 1980, essentially as the consequence of de-collectivizing agriculture, shifting responsibility for farming to households and higher food grain procurement prices. They note that when so much of the country's poverty is found in its rural areas, it is not surprising that agricultural growth plays an important role in China, as in other developing countries. They are more sceptical regarding the score card for trade reform, concluding that:

> While the country's success in trade reforms may well bring longer term gains to the poor … the experience of 1981-2001 does not provide support for the view that China's periods of expanding external trade brought more rapid poverty reduction (Ravallion and Chen 2004: 31).

In the next phase (the post-takeoff phase), successful development calls for the expansion of the manufacturing and service sectors with continuous structural and technological upgrading. During this potentially high growth phase, the role of the government is to maintain macroeconomic stability, overcome possible coordination failure and act as an umpire in promoting growth pioneers. Successful countries have evolved along the product cycle determined by the path of dynamic comparative advantage. They climbed the product ladder one wrung at a time (from simple textiles to computer chips), relying on their most abundant factors in each development phase. Technological leap-frogging has typically led to failure. The experience of East Asia has clearly demonstrated that a careful structural transformation as outlined above generates a growth process that is pro-poor. Other key elements of the East Asian development model were, in addition to the treatment of agriculture and education in the pre-takeoff phase, sound macroeconomic management and stability, and openness; the emulation of the US as the technological leader and strengthening intra-East and South East Asia connections (Thorbecke and Wan 2004).

The above analysis applies particularly to countries that have not taken the necessary steps to develop their agricultural sector and consequently have not yet reached the takeoff point. Many Sub-Saharan countries are prime examples of agricultural exploitation leading to agricultural output stagnation and the short-circuiting of the structural transformation. The industrialization strategy, based on capturing a surplus

from the stagnating agricultural output, is bound to fail and can have devastating consequences on poverty.

6 Concluding remarks

The preceding review and critical analysis demonstrate that globalization can affect poverty indirectly through the 'growth effects' as well as directly through channels such as changes in relative goods' prices in favour of (or against) wage goods, changes in relative factor prices induced by trade or factor mobility; the nature of technological progress and the technological diffusion process; volatility and vulnerability; the nature of the worldwide flow of information; and global disinflation. Likewise, institutions can be designed so as to transmit and amplify the potential positive benefits of the various mechanisms through which globalization affects poverty, or alternatively, to act as a brake (or, at the most, block) the transmission of those effects.

While there is a widely-held belief that growth reduces the incidence of poverty, a key issue is which structure and pattern of growth best contributes to poverty alleviation. The resulting distributional effects of globalization are known to produce winners and losers, both between and within countries. In particular, the losers (among whom are certain categories of poor) are often extremely vulnerable to changes in absolute and relative prices of wage goods. This calls for effective complementary policies and safety nets to be in place at both national and global levels.

Our review also raises the issue as to whether the present form of globalization/integration is conducive to the growth-cum-structural transformation process, which is capable of engendering and sustaining *pro-poor* economic growth and favourable distributional consequences. Contrary to the income convergence thesis, it is possible for globalization to generate adverse distributional consequences at the national and global levels which could slow down or even reverse the present poverty alleviation trend.

Hence, policymakers need to design and implement an active development strategy not only to benefit from, but also to help counteract the negative effects of the immutable forces of globalization. Globalization should not be viewed as a reliable substitute for a domestic development strategy (Sanchez 2003). It is not enough for governments to assume an active role in liberalizing trade and capital movements and de-regulating their economies while passively waiting for the fruits of the Washington consensus and the market forces of globalization to pull them on a fast track to development. Instead, governments need to pursue both active liberalization and active domestic development policies.

In this context, it is pertinent to refer to the remarks by Milanovic, who made a careful historical analysis of the most recent period of globalization:

> the last two decades, which witnessed expansion of globalization, are, in terms of overall growth and income convergence between poor and rich countries, vastly less successful than the preceding two decades The attempt

> to explain divergence of incomes by 'eliminating' the countries with 'bad' policies and focusing solely on those with 'good' policies is flawed because the successful countries, and China in particular, did not follow the orthodox economic advice (Milanovic 2003: 676).

We have argued particularly for the need for strategic integration: globalization offers large potential benefits for the countries that decide to engage strategically and actively in the globalization process. But benefits are neither automatic nor guaranteed. Only countries that create patterns of comparative advantage towards high-skill and high-productive activities will gain significantly from globalization. Passive liberalization may lead to marginalization. At the same time, countries which have not yet reached the critical threshold, need (i) to invest in agriculture in order to reach the takeoff-point to allow the structural transformation of their economies to proceed; and (ii) to strengthen institutions of social protection.

As Kanbur (1998) notes, the central policy dilemma is 'how to take advantage of the undoubted opportunities that integration into the world economy affords for rapid growth, while managing the attendant risks for domestic income distribution in its different dimensions'. Rodrik (1997) takes a similar position, arguing that while globalization is a positive trend, globalization can succeed and be sustained only if appropriate domestic measures are undertaken to cushion the impact on groups that are adversely affected. Yet, as Tanzi (2001) notes, the unwillingness or inability to tax international mobile financial capital in the process of tax competition and in fear of capital flight and asset migration, has, among other conditions termed as 'fiscal termites', contributed greatly to the erosion of the capacity of governments to raise revenues for redistributional purposes.

Others argue the need for alternative, more equitable forms and processes of globalization to start with. This requires a much better grasp of the concept of *pro-poor globalization* than what we presently hold. Whichever position one takes in this policy debate, it is critical to conduct well-focused empirical studies towards understanding better the globalization-poverty nexus in a country- or region-specific context, since successful policies for maximizing benefits from globalization while protecting the poor can only be designed and implemented in such a context.

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