

UNU World Institute for Development Economics Research  
(UNU-WIDER)

## WIDER Annual Lecture 9

# **The World is not Flat: Inequality and Injustice in our Global Economy**

Nancy Birdsall

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## CONTENTS

LIST OF TABLES AND FIGURES	iv
FOREWORD	v
AUTHOR'S ACKNOWLEDGEMENTS	vi
ABOUT THE AUTHOR	vii
INTRODUCTION	1
PART I INEQUALITY WITHIN COUNTRIES: WHY IT MATTERS FOR DEVELOPMENT	4
1.1 Inequality can stall growth: textbook economics versus market and government failures	6
1.2 Inequality tends to undermine good public policy	15
1.3 Inequality tends to inhibit effective collective decisionmaking	17
PART II GLOBALIZATION IS DISEQUALIZING	18
2.1 Recent trends of global inequality	19
2.2 Desequalizing globalization: three reasons	22
CONCLUSION: MANAGING GLOBALIZATION	33
3.1 A global social contract	33
3.2 Addressing global market failures	34
3.3 Just global rules and full and fair implementation	35
REFERENCES	37

## LIST OF TABLES AND FIGURES

Table 1	Average years of schooling by wealth in Latin America and East Asia, 1996-2002	14
Table 2	Annual GDP per capita growth rates by region, 1980-2003	21
Table 3	Financial crises and changes in income shares in East Asia and Latin America	29
Figure 1	Poverty and inequality across countries	2
Figure 2	Regional inequality by decade, 1970-2000	2
Figure 3	Income per capita growth and income Ginis for Latin America and East Asia, 1960-90	10
Figure 4	Inequality and per capita income growth in developing and rich countries, 1970-2000	12
Figure 5	UTIP-UNIDO wage inequality (Theil index) for select countries, 1980-99	21
Figure 6	The global market does not reward the wrong assets: open, globalizing countries heavily dependent on commodity prices have not grown	24
Figure 7	Open, globalizing countries heavily dependent on commodity prices have not grown, despite having comparable tariff rates to other countries	24
Figure 8	Emigration rates to all OECD countries by education level, 2000	25
Figure 9	Relative returns to education in Latin America	25

## FOREWORD

The WIDER Annual Lecture is a major event in the UNU-WIDER calendar. It provides an opportunity for a distinguished speaker to present his or her analysis and views on a topic related to WIDER's work on global development. The 2005 Annual Lecture—the ninth in the series—was given at the Marina Congress Center in Helsinki on 26 October 2005 by Nancy Birdsall, President of the Center for Global Development in Washington.

The title of the lecture is 'The World is not Flat: Inequality and Injustice in our Global Economy'. The reference to 'flatness' alludes to the more level playing field due to globalization that has enabled China, India, and others to start catching up with the living standards of rich countries. But as Birdsall points out, the world is far from flat. In particular, unequal opportunities exist and persist both at the level of households within countries and at the level of nations in a global context; indeed the same forces of globalization are likely to exacerbate these inequalities.

High inequality might be regarded as a lesser evil if it has a positive or neutral impact on growth prospects, or if it is simply a passing phase that successful countries have to endure on route to a prosperous future. However, as discussed in the Lecture, inequality can have significant negative repercussions for national and global development. More importantly, the negative impact of inequality is likely to be more severe in developing countries with weak markets, weak governments, and fragile social structures. Here inequalities can interact with institutional deficiencies to create a vicious cycle of economic and political decline, trapping countries and even whole regions in poverty. By way of illustration, Birdsall draws on her deep knowledge of Latin America and East Asia and contrasts the recent fortunes of these two regions.

At the global level, inter-country inequality appears to have no benign effects. This is a crucial point in the globalization debate, because globalization is commonly held to be inherently disequalising. Birdsall advances three reasons why this is so. First, global markets work better, increasing the reward to more productive assets which are disproportionately owned by better-off individuals in richer countries. Second, globalization results in new types of externalities and market failures which poorer persons and weaker nations are ill equipped to handle. Finally, globalization creates a need for continuous revision of the rules governing the global economy; this is exploited by rich countries that use their bargaining power to ensure that the rule changes favour their own narrow interests.

Birdsall expands on each of these arguments and goes on to suggest ways in which the problems might be addressed. By deepening our understanding of the links between globalization and inequality, the Lecture is a valuable addition to the ongoing debate on the merits and disadvantages of a globalized world.

Anthony Shorrocks  
Director, UNU-WIDER

## **AUTHOR'S ACKNOWLEDGEMENTS**

This lecture is based largely on earlier research papers and essays. I am grateful to many seminar and conference participants, including at the Brookings Institution, Yale University, the Carter Center, the United Nations Development Programme, the 2005 UNU-WIDER conference on The Future of Development Economics, and especially at the Center for Global Development, who commented critically and energetically on those earlier efforts, and in the case of the Center for Global Development, on an earlier version of this lecture. I thank especially several collaborators, co-authors, and friends who influenced my thinking over many years on the ideas expressed here and on the analytic challenges they pose, especially Carol Graham, Jere Behrman, and two fine development economists lost to us: Juan Luis Londono and Richard Sabot.

I am grateful to Anthony Shorrocks and his colleagues at UNU-WIDER for giving me the opportunity and the incentive to pull together those earlier efforts and for their patience and help in the last stages of preparing the lecture for publication.

This lecture would not have been completed without the help of Gunilla Pettersson. I thank her heartily for her careful, cheerful, creative, and always intelligent help.

## ABOUT THE AUTHOR



Nancy Birdsall is the founding President of the Center for Global Development. Prior to launching the center, Birdsall served for three years as Senior Associate and Director of the Economic Reform Project at the Carnegie Endowment for International Peace. Her work at Carnegie focused on issues of globalization and inequality, as well as on the reform of the international financial institutions. From 1993 to 1998 as Executive Vice-President of the Inter-American Development Bank, the largest of the regional development banks, she oversaw a US\$30 billion public and private loan portfolio. Before joining the Inter-American Development Bank, she spent 14 years in research, policy, and management positions at the World Bank, most recently as Director of the Policy Research Department.

Nancy Birdsall is the author, co-author, or editor of more than a dozen books and monographs, including, most recently, *Delivering on Debt Relief: From IMF Gold to a New Aid Architecture*, *Population Matters: Demographic Change, Economic Growth and Poverty in the Developing World*, *Washington Contentious: Economic Policies for Social Equity in Latin America*, and *New Markets, New Opportunities? Economic and Social Mobility in a Changing World*. She has also written more than 75 articles for books and scholarly journals published in English and Spanish, and shorter pieces of her writing have appeared in numerous US and Latin American newspapers and periodicals.





## INTRODUCTION

I feel greatly privileged to follow so many distinguished predecessors in delivering this lecture. I have chosen to discuss inequality and injustice in the world, which is daring on my part as WIDER is home to world-class scholarship on inequality and development. I refer for example to the work of Andrea Cornia who, with Richard Jolly at UNICEF and Frances Stewart, insisted on the importance of injustice that was too often the unintended consequence of early structural adjustment programmes, and then here at WIDER began what has become an impressive effort to assess and refine country data on income and consumption inequality.<sup>1</sup> And I refer of course to Tony Shorrocks, who continues to make key contributions to economists' conceptions and measures of inequality. I feel daring as well because I am an American who has been deeply influenced in my own training and thinking by the tradition in my country of emphasis on individual responsibility and relative tolerance for unequal social and economic outcomes. Yet here I am in Europe and particularly in Nordic Finland, where there is a long tradition of intolerance for unequal outcomes and of emphasis on some version of a redistributive social contract.<sup>2</sup>

The title of this lecture is an allusion to Thomas Friedman's 2005 book entitled *The World is Flat: A Brief History of the Twenty-first Century*. Friedman argues that in today's highly integrated and competitive global economy, the US and other advanced economies can no longer count on the past comforts and advantages of the mountaintop. But focusing on the flattening process (between the US and China, for example) overlooks (literally and figuratively) half the world's population—those countries and people within countries in ruts and craters beneath the surface. What are the implications of global economic integration for those countries and those people in this highly 'not-flat', unequal world? And in particular, what is the challenge that this inequality poses for the development process itself in the developing world?

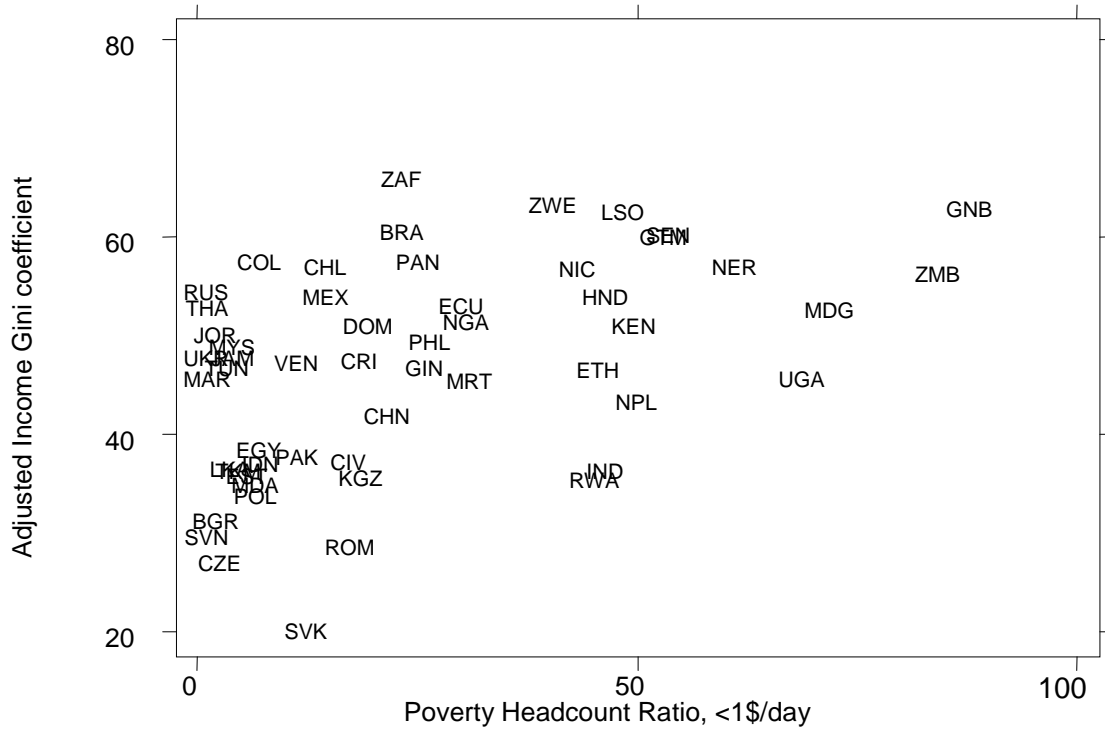
In Part I, I address the question of whether and how money inequality (hills and craters) matters to people, and what it has to do with the broader issue of injustice. That is a question best addressed at the country level. There is a rich literature on country inequality and for many people the country in which they live constitutes a key reference group. I then turn in Part II to a fundamental problem of globalization: that it tends to benefit more those already ahead—the currently 'rich'

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<sup>1</sup> See Cornia, Jolly, and Stewart (1987); Cornia (2005); and Shorrocks and van der Hoeven (2005).

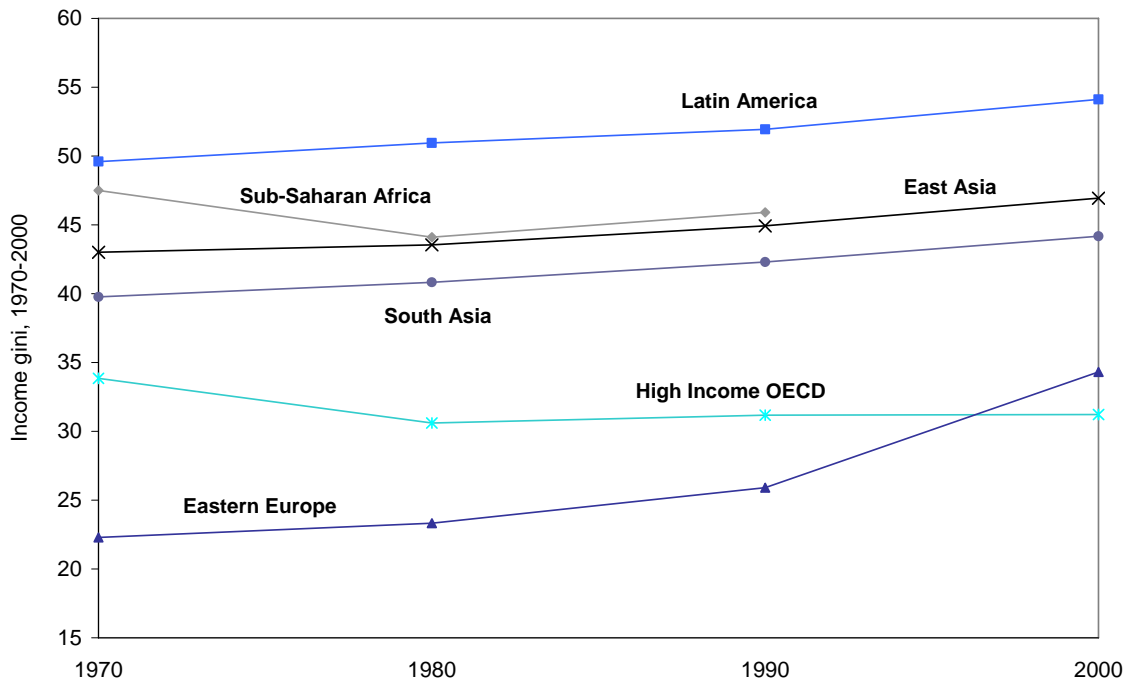
<sup>2</sup> In this context at least I would say that Jagdish Bhagwati who gave the 2000 WIDER Annual Lecture represents the American tradition, and Frances Stewart who gave the 2001 WIDER Annual Lecture, and Amartya Sen, represent the European/South Asian tradition.

FIGURE 1  
POVERTY AND INEQUALITY ACROSS COUNTRIES



Source: Birdsall (2001).

FIGURE 2  
REGIONAL INEQUALITY BY DECADE, 1970-2000



Sources: WIDER WIID2a, Sub-Saharan Africa data from Birdsall (2001).

countries—and within developing countries the currently ‘rich’ relative to the poor and middle income strata. In the conclusion I briefly suggest what can be done about the resulting challenge to global security, stability, shared prosperity, and most fundamentally to global social justice: how to reconcile the reality that we have a global economy but not an effective global polity.

A word on definitions and on regional patterns. *Inequality* is, of course, a relative concept, and except where I specify otherwise I am referring to money inequality, that is, inequality of income, consumption, or wealth (the latter is everywhere more concentrated but less often measured). By *poverty* I refer to the condition of people who are poor in absolute terms, using the World Bank standard of US\$2 a day (in 1985 dollars), and for extreme poverty of US\$1 a day. Across countries there is at best a weak association between absolute poverty and inequality (Figure 1). I use the term *equity*, or social equity, as in an ‘equitable’ society, to refer to the idea of justice or fairness in the processes that lead to outcomes such as income, and in contrast to outcomes or income *per se*. A society with relatively high income inequality might be an equitable society if the observed inequality were the outcome of an entirely fair process—in which some worked harder or took more economic risks with resultant greater economic gains than others. Equity is sensibly thought of as equality of opportunity and is a more satisfactory concept from a normative point of view; but it is harder to measure. I argue that in developing countries high money inequality is likely to be a sign of processes that are not equitable.

Figure 2 summarizes information over time on inequality across regions, including the advanced industrial economies, using the Gini coefficient. Inequality is lower in the advanced economies than in developing country regions, and was lower still in the transitional economies of Eastern Europe until the mid-1990s. Within regions, and more so within countries (not shown), inequality does change over time. Cornia (2003) and Galbraith and Kum (2002), among others, have shown that in many countries there has been a marked trend of increasing inequality since the early 1980s (see also Sala-i-Martin 2002). Cornia (2003) looks at income and consumption inequality across households and at least implicitly attributes the trend to the increasing recourse to markets without sufficient intervention by governments to ensure that the poor are not left behind. Galbraith and Kum (2002) look at wage inequality in manufacturing and attribute the trend to the virtually worldwide acceptance of the priority of stabilization over employment generation in the last two decades, and the resulting emphasis on fiscal and monetary restraint since the 1980s (following the collapse of the Bretton Woods fixed exchange rate system). Growing inequality appears to be the case in many industrialized countries including the US, the UK, Japan, Ireland, and New Zealand, in many developing countries including China and India, and in most of the transitional, post-Communist economies of the former Soviet Union and Central and Eastern Europe (Smeeding 2002; Milanovic 2005).

## PART I INEQUALITY WITHIN COUNTRIES: WHY IT MATTERS FOR DEVELOPMENT

For the most part, mainstream economists have not been concerned with the apparent trend of rising inequality. The assumption of textbook economics is that inequality is likely to enhance growth by concentrating income among the rich, who save and invest more, and by creating a necessary incentive for individuals to work hard.<sup>3</sup> Moreover, as Kuznets suggests, increasing inequality may be a natural outcome of the early stages of development, as people begin the shift from low-productivity subsistence agriculture to high-productivity sectors. For economists, inequality has typically been at worst a necessary evil and at best a reasonable price to pay for growth.

For development economists, inequality has not been the central policy issue, but rather the reduction of absolute poverty. Even Kuznets' analysis is not an exception; he treats inequality as an immutable (and thus not policy sensitive) outcome of the early stages of growth, which in any event would be eventually self-correcting as growth proceeded (Kuznets 1955; Chenery and Syrquin 1975). Only beginning in the 1990s, once the fall of the Berlin Wall had liberated the mainstream from the taboo of Marxian thought, did inequality begin to be viewed as a possible cause of low growth, and thus as a phenomenon that mattered, at least for understanding growth itself. In the past 15 years there has finally been more theoretical and empirical work on inequality and development, much of it ably reviewed in major reports from the United Nations Development Programme (UNDP), Inter-American Development Bank (IDB), and recently by the World Bank.<sup>4</sup>

Still there is no agreement among economists, and no particular attention among development practitioners, to the likelihood that inequality matters—for growth itself or for poverty reduction, or for any larger definition of development or of individual well-being.

Yet if people care about their relative income status then *ipso facto* inequality matters. That they do, to some extent, has long been remarked; consider Adam Smith (1776), who noted that for a man to retain his dignity, he may in one society

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<sup>3</sup> For example, Finis Welch entitled his 1999 address to the American Economics Association 'In Defence of Inequality'.

<sup>4</sup> The Human Development Report, *Consumption for Human Development* led by Richard Jolly, included analysis of consumption inequality (UNDP 1998). I urged that inequality be addressed in the WDR-like report of the IDB. The 1998/9 IPES of the IDB, led by Ricardo Hausmann, the Chief Economist, was entitled *Facing Up to Inequality in Latin America*. The WDR (World Bank 2006a), led by Francisco Perreira and Michael Walton, is entitled *Equity and Development*. For a review from the perspective of new endogenous growth theories in economics, see Aghion, Caroli and García-Peñalosa (1999).

need enough income to buy a linen shirt, to Thorstein Veblen (1970) who noted that the absolutely well-off worry about their status relative to the more absolutely well-off.<sup>5</sup> Hirshman (1973) observed that drivers stuck in the slow lane in a tunnel become deeply frustrated if their lane never moves—quite independent of their type of car. Because it is relative and not absolute income that matters (and expectations about future relative income as Hirshman’s tunnel metaphor illustrates), economic growth and subsequent increases in a country’s average income do not seem to increase the average level of happiness in a country (Easterlin 1995). What matters for people is their relative not their absolute income.<sup>6</sup> Graham and Felton (2005) report that based on happiness surveys, people in Nigeria are as happy as people in France despite the huge discrepancy in per capita income.

In short, inequality of absolute income seems to matter: more obviously to people at the low end, who may resent the better-off, but probably to some at the high end too, who may enjoy their own affluence less if others are visibly worse off. Inequality is probably most bothersome (to the rich as well as the poor) when low income is persistent for identifiable groups of people and thus most obviously unjust—rooted in racial or other discrimination, for example, or in inadequate access to education for low-income children. Reducing inequality may therefore be an end in itself for some people and in some societies.

There are also, however, instrumental reasons why inequality matters—reasons that should be of interest to development economists concerned primarily with growth and absolute poverty. Money inequality in developing countries matters for at least three (instrumental) reasons:

- (i) Where markets are underdeveloped, inequality inhibits growth through economic mechanisms;
- (ii) Where the institutions of government are weak, inequality exacerbates the problem of creating and maintaining accountable government, increasing the probability of economic and social policies that inhibit growth and poverty reduction;
- (iii) Where social institutions are fragile, inequality further discourages the civic and social life that undergirds the effective collective decisionmaking that is necessary to the functioning of healthy societies.

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<sup>5</sup> Graham and Felton (2005) provide a survey of recent studies linking measures of ‘well-being’ (or reported ‘happiness’ in surveys of individuals) to prevailing levels of inequality. Results depend on setting, definition of reference group, and the particular measure of well-being. In Europe and the US inequality has generally negative effects on reported measures of well-being.

<sup>6</sup> Graham and Pettinato (2002) make the point that it is peoples’ perceptions about their current and future income relative to others that is important.

Note that in all three cases, it is not inequality itself that is the problem but the interaction of inequality with weak markets or with unaccountable or incompetent governments (increasingly labelled weak ‘institutions’ in the literature on growth—see for example Acemoglu, Johnson, and Robinson 2000). Weak markets, weak governments, weak institutions—these are the very characteristics that define a country as ‘developing’. Some of the doubts of economists about the relevance of inequality are due to the lack of clear evidence that across countries over time inequality has had much influence on growth. But that evidence is based on studies of the advanced economies (among which the US with its relatively high inequality has been a fast grower compared to Europe) and on studies that include both the advanced and developing countries. When a distinction is made, inequality is associated with reduced growth in developing countries but not in developed ones.<sup>7</sup>

Seeing country inequality as a negative force in interaction with weak institutions suggests that reducing inequality would not in itself lead automatically to higher growth or better government or more stable and healthy societies. On the other hand, failing to see country inequality as a negative force is to overlook policies that might address it and reduce its perverse effects—and to ignore it altogether is to invite setbacks on the development road.

### **1.1 Inequality can stall growth: textbook economics versus market and government failures**

The assumption of textbook economics is that a tradeoff exists between augmenting growth and reducing inequality. Kuznets and others explore causality in one direction—positing that growth in the early stages of development might cause inequality. The assumption about the other direction of causality—that inequality would enhance growth—is grounded in two simple observations. The first is that a high level of saving, and resulting investment, is a prerequisite of rapid growth, so that income must be concentrated in the hands of the rich, whose marginal propensity to save is relatively high compared to that of the poor (Kaldor 1961). A related point is that large investments in infrastructure and industry are critical to development; in the absence of a deep and well-functioning capital market, wealth and income need to be concentrated to generate the necessary minimum resources.<sup>8</sup>

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<sup>7</sup> Barro (1999) finds that inequality is bad for economic growth for countries with per capita GNP below US\$5000, and good for growth for countries with GNP above that level.

<sup>8</sup> With this in mind, many developing countries embraced the need for the state to assume the commanding heights of the economy and used tax and donor resources to finance state-led industrial investments throughout much of the post-war twentieth century. This approach almost certainly, and ironically, led to increased concentration of income. Worse, in some countries the later privatization of those investments further increased income concentration, though there is also good evidence that privatization of water, electricity, and other utilities has improved access to these services of the poor (Nellis and Birdsall 2005).

The second observation is that inequality provides an incentive for individual effort—for hard work, innovation, and productive risk-taking—which ultimately ensures higher output and increasing productivity, and thus higher average income and rates of growth. For economists, these incentive effects of inequality are the backbone of the moral hazard argument against tax-financed redistribution—that such transfers undermine individual responsibility and the work ethic (Okun 1975).

*Constructive inequality is good for growth*

That inequality creates positive incentive effects at the microlevel implies that inequality is ‘constructive’, that is, that it reflects differences in individuals’ responses to equal opportunities and is therefore consistent with efficient allocation of resources in an economy. Let us define ‘destructive inequality’ as that inequality which reflects privileges for the already rich and blocks potential for productive contributions of the currently less rich, and therefore contributes to economic inefficiency and reducing rather than enhancing the potential for growth.<sup>9</sup> Then for any given society the question becomes the extent to which measured money inequality is mostly constructive or destructive.<sup>10</sup>

Certainly one rationale for the existence of income inequality is that societies care about equality of opportunity, not of income itself. It follows that a sensible interpretation of destructive inequality is that it reflects mostly inequality of opportunity. Inequality of income in an equal-opportunity society would then presumably be wholly constructive in the economic sense, that is perfectly conducive to efficient use of resources and thus to growth (and poverty reduction). That the US has long been considered an equal-opportunity society is, no doubt, behind the greater tolerance of relatively high income inequality. In an equal-opportunity society, there would be high lifetime mobility (up and down) for individuals, and high intergenerational mobility; children’s place in the distribution of lifetime income would be independent of their parents’ place. (In fact, John Roemer’s analyses of wage earnings by education suggest a striking lack of equal opportunity between blacks and whites in the US; and empirical work on social mobility in the US shows it has not been a factor in reducing measured inequality

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<sup>9</sup> Rawls (1971) argues that unequal systems of rewards and incentives may be justified if they optimize the position of the least advantaged by generating incentives for wealth creation and raising the income of the least advantaged as they share in overall growth. I am not convinced, however, that the least advantaged would not choose truly equal opportunity over an increase in their relative income.

<sup>10</sup> There is not only a measurement problem in distinguishing the two types of inequality, but a conceptual problem short of an infinite period model. If a person is neglected by her parents, is unschooled, and unmotivated, and earns a low wage in the workforce, is the resulting inequality constructive and ‘efficient’ given her lack of skills, or destructive given her earlier missed opportunity? Is a large bequest ‘constructive’ because it is the outcome of an incentive in the bequeathing generation to work hard, or destructive because it creates inequality unrelated to any incentives for the beneficiary?

(Roemer 2000)).<sup>11</sup> The view of the US as a highly mobile society compared to Western Europe is the result of its higher average income growth, which has lifted all boats, not a greater amount of switching of the positions of individuals or their children in the overall income distribution (Sawhill 2000).

New opportunities and the hope for upward social mobility may help explain voters' acceptance, at least for much of the 1990s, of market reforms in Latin America and Eastern Europe (even as inequality stayed high in Latin America and greatly worsened in Eastern Europe). Evidence here of the link between parents' income and education and children's education indicates intergenerational mobility is very low compared to the US, even though educational opportunities, conventionally measured, have increased substantially in the last two decades (Behrman, Birdsall, and Székely 2000). Voters may have seen the reforms as creating new opportunities in what could become more meritocratic, competitive systems, in which market signals would reward education and hard work more than had centralized, statist systems (Birdsall and Graham 2000).<sup>12</sup>

### *Destructive inequality is bad for growth*

There are no internationally comparable measures of opportunity or of mobility, and so as development economists, we are driven back to measuring 'money' inequality—inequality of income, consumption, and, when we are especially ambitious, of wealth. From at least one point of view that is perfectly reasonable. Suppose that money inequality has a measurable effect on growth—which differs across countries. Suppose that the differences provide an indication of country-specific differences in the extent to which measured inequality comprises a destructive versus a constructive component. To the degree inequality is growth-inhibiting it is, by our definition, inefficient from an economic point of view, and destructive from a social point of view. Assessing the effects of money inequality on growth within and across countries can therefore provide insight about the extent to which that inequality is 'destructive'. In this sense the effect of inequality on growth provides a rough indicator of inequality of opportunity and limited social mobility in a particular setting. This brings us to the crux of why inequality matters, especially in developing countries. It matters because the evidence is that it has a large 'destructive' component, that is, it is associated with unequal opportunities and contributes to lower growth than otherwise might be possible.

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<sup>11</sup> Gary Fields (2000), using panel data on incomes of workers shows that in the 1980s, when wage inequality was increasing, those initially at the bottom were more likely to be moving downward over five-year periods than those in the middle or at the top.

<sup>12</sup> But as of late 2005 the political popularity of a new generation of populist leaders in several countries is a worrying sign that those hopes are not persisting.



### *A digression on my own experience*

Our individual perspectives on economic development issues are shaped in part by our personal experience. In the late 1980s I spent several years working on Latin America in the World Bank. I then returned to the research side of the World Bank and became involved in a major study of East Asia's astonishing postwar growth, published in 1993 and titled *The East Asian Miracle: Economic Growth and Public Policy*.<sup>13</sup>

What was astonishing about postwar East Asia was the tremendously high rates of investment (and savings) that prevailed in most countries (as in China today), both private and public. These seemed to be combined with healthy rates of total productivity growth—though that part of the story is still more controversial. Macroeconomic stability, competitive exchange rates, and openness in the form of an export push all seemed to matter. The emphasis on exports and the resulting healthy pressure to compete effectively in global markets became the principal theme of the study.

But behind export success in the 'economic' sector were other factors rooted in equally amazing and rapid changes in household behaviour. Those other factors included unprecedented gains in small farmers' agricultural productivity, high demand for schooling including of girls, and declines in fertility far more rapid and at lower income levels than had occurred in the industrialized economies. All these combined in various ways to generate high annual wage and income gains over many years for households that, in a virtuous circle, fuelled continuing demands for education, further declines in fertility, and so on.

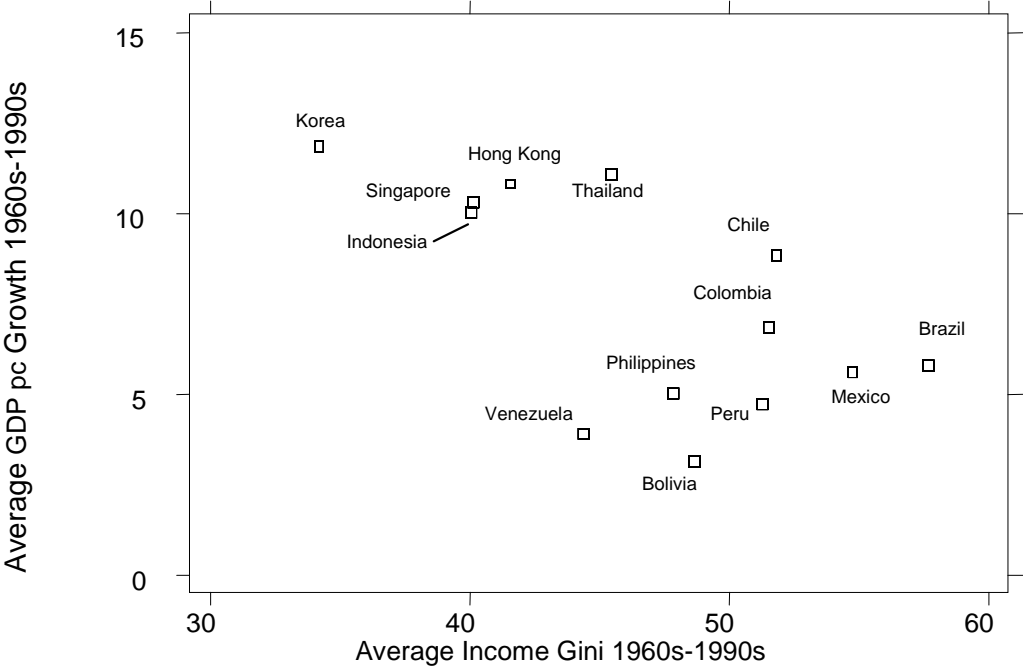
I was already familiar with many aspects of these household-level changes because of my own earlier research and study of population change, education, female employment—the microeconomics of household behaviour—in the postwar developing world. What was (for me at least) a new insight was that in Taiwan, Korea, Hong Kong, Singapore, and later in Malaysia, Indonesia, and Thailand, rapid growth had not, as Kuznets' theory suggests, led to higher inequality. Rapid growth combined with low initial levels of inequality in these economies suggested that the textbook tradeoff between efficiency and growth on the one hand, and equality on the other, did not necessarily exist in the real world. Initial levels of low inequality, associated for example with the post-war redistribution of farm land in the northern economies of East Asia (a positive external shock), seemed to be key, as did public investment in education, agricultural extension, and other programmes that reached households in rural areas.

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<sup>13</sup> As the head of the department responsible for the study, I followed closely and learned from new research of others on sources of productivity growth, on the agricultural and financial sectors, and on trade and fiscal policy. In addition, I led the work on labour markets and education along with my colleague Richard Sabot, then at Williams College.

In the summer of 1993 I left the World Bank to become the Executive Vice President of the Inter-American Development Bank (IDB). By that time I was already convinced that inequality mattered to growth. An earlier version of Figure 3 had appeared in the *Miracle* book, and in this, as in earlier updates of the figure, I worried about the implications for Latin America—of what, as the figure illustrates, is not only that region’s lower growth and higher inequality compared to East Asia, but even within the region the association across countries between low growth and high inequality. My work on Latin America included three years on education and health problems and policies in Brazil, one of the world’s most unequal countries. For me the contrast between fast-growing East Asia, with its low inequality, and slow-growing Latin America, with its high inequality, now cried out for deeper explanation.<sup>14</sup> Subsequent research by many economists has only strengthened my conviction that inequality in developing countries, in all its various forms, is mostly destructive; not only in Latin America where conventional measures of income inequality are high, but also in other parts of the developing world where our conventional indicators are not so high, but there are plentiful signs of injustice, indignity, and lack of equal opportunity for many people.

FIGURE 3  
 INCOME PER CAPITA GROWTH AND INCOME GINIS  
 FOR LATIN AMERICA AND EAST ASIA, 1960-90



Source: Birdsall (2001).

<sup>14</sup> One of the first uses of my executive power at the IDB was to encourage and support the creation of the position of chief economist, and as soon as that position was filled to push for an early major report on inequality in Latin America. That report, *Facing Up to Inequality*, was published in 1998/9.

I have imposed this brief personal sojourn to emphasize the point that inequality deserves attention, at least as a proxy for other problems, in the hope that those of you more familiar with development challenges in Eastern Europe, the Middle East, and Central and South Asia will suspend what may be your prevailing disbelief that inequality matters, and consider what aspects of inequality—if not money inequality then other indicators of unequal opportunity or injustice or limits on individuals' identity and dignity—matter in these other settings.

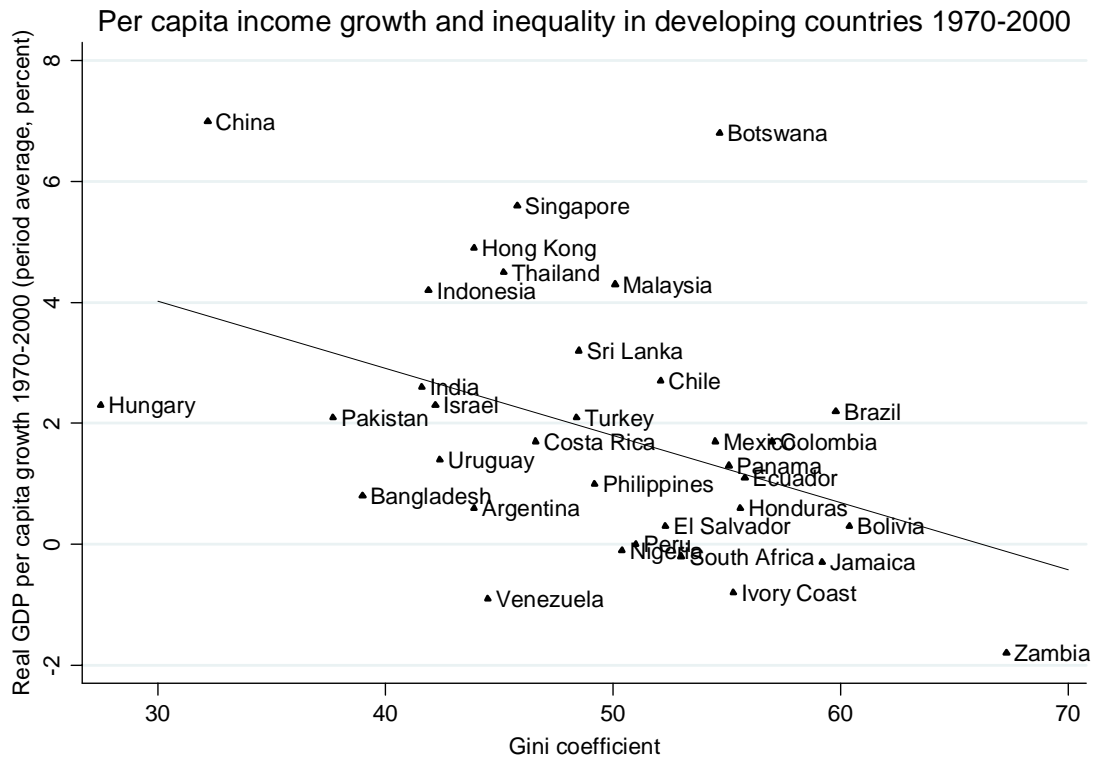
*Inequality matters because developing countries are not developed*

The key point, however, is that inequality matters especially in developing countries, because by definition (in the nature of being 'developing') those countries' markets are relatively weak and their governments less effective in compensating through public policy for the weakness of their markets and the fundamental failures of markets (that prevail everywhere). Inequality may be constructive in the rich countries, in the classic sense of motivating individuals to work hard, innovate, and take productive risks. But in developing countries it is more likely to be destructive. That may explain why, as Figure 4 suggests, inequality is more clearly associated with low growth in poor rather than in rich countries.

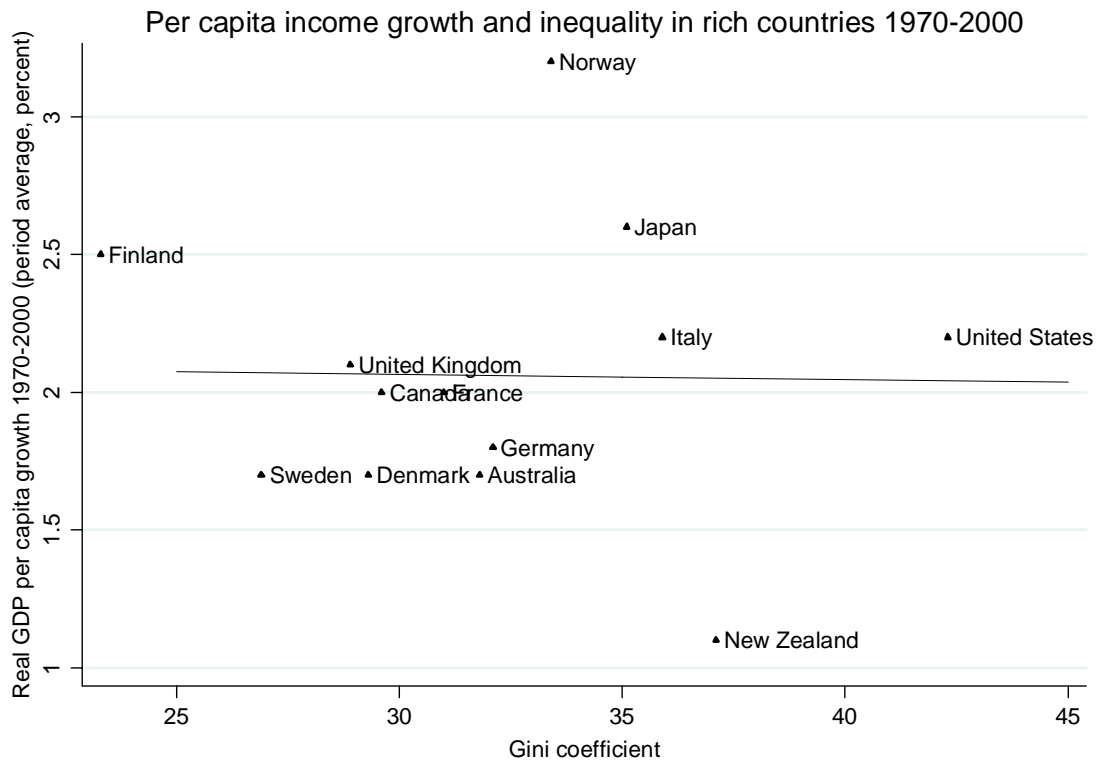
In the 1990s, through the efforts of Lyn Squire and Klaus Deininger at the World Bank and Andrea Cornia and others at WIDER, cross-country data on inequality of reasonable quality became available and empirical work on inequality and growth began to appear. Early analyses tended to confirm an association of high income inequality with lower growth. Initial theorizing put the explanation in the political sphere, the result of the median voter, who is relatively poorer where inequality is high, voting for inefficient redistribution financed by growth-reducing higher taxes (Alesina and Rodrik 1994). The theory hardly seemed to square with the reality that policies in unequal countries are not greatly shaped by the relatively poor median voter (even where there is democracy), and moreover that lack of any evidence that redistributive policies, measured in terms of the marginal tax rate, are associated with lower growth (Easterly and Rebelo 1993). Indeed, the East Asian example was that redistribution in the form of land reform and mass education had supported healthy growth (Birdsall, Ross, and Sabot 1995).

More recent economic models focus on the likelihood that inequality exacerbates the effect of capital and other market failures on growth. When creditworthy borrowers cannot borrow because they lack collateral to comfort lenders (given imperfect information, a market failure in itself), then their lack of income or wealth limits their ability to invest—in their own farms, small businesses, and in the health and education of their children.

FIGURE 4  
INEQUALITY AND PER CAPITA INCOME GROWTH  
IN DEVELOPING AND RICH COUNTRIES, 1970-2000



Note: coefficient: -0.105; t-statistic: -2.65 (statistically significant); robust se: 0.04.



Note: coefficient: 0.055; t-statistic: 0.76 (not statistically significant); robust se: 0.072.

Source: World Bank (2006b); WIDER WIID 2.0a (2005).

Capital market weakness combined with inequality of wealth can undermine efficiency and growth even in the absence of absolute poverty. Aghion, Caroli, and García-Peñalosa (1999) set out a model in which given diminishing returns to capital and given some degree of imperfection in capital markets, inequality implies that those with more wealth will have a lower marginal productivity of investment, while those with less wealth cannot exploit higher return investments. The unequal distribution of wealth reduces aggregate returns to investment in an economy, and thus reduces growth.

It is not income inequality but inequality of financial wealth or other assets that interacts with weak capital markets to reduce growth. We lack data on financial wealth across households. But increasing evidence suggests that other assets—land and education—tell the same story. Latin America still appears to bear the costs of its historic land inequality. Carter (2004) shows that concentration of land ownership is associated, over long subsequent periods, with a concentration of income, even in countries where the economic relevance of agriculture has diminished. Birdsall and Londoño (1997) show that across countries, inequality in the distribution of education reduces growth, and that once inequality of land and education are accounted for, inequality of income washes out as a factor affecting growth. In that respect, market economies in Latin America do not operate differently from those in East Asia—it is just that they operate in a context of high concentration of land and education.

Admittedly, it is not easy to distinguish the negative effect of inequality *per se* (whether of income, wealth, education, land) interacting with weak markets from the effects of high rates of poverty. The question is whether that matters much. The associations among poverty, income inequality, and growth, together put a high premium on reducing poverty and inequality by directly attacking poor people's lack of land, education, and access to credit markets and by concentrating on improving the working of capital, insurance, land, and other markets.

As with weak markets, weak governments exacerbate the effects of inequality (of income, assets, education, and so on) on growth. Repressed interest rates and directed credit programmes that end up limiting access to credit, except for privileged insiders, worsen the problem of inherently imperfect capital markets. Lack of adequate public spending on basic health and education means that public policy is not correcting for the inherent inability of markets alone to compensate for differences across households in endowments of all kinds. Behrman, Birdsall, and Székely (2000) show that differences across countries in social mobility, measured by differences in the effect of parents' income and education upon their children's education, are robustly and systematically affected by differences in two factors: public spending on primary education and the depth of financial markets. Children's fates are closely linked to their parents' endowments—reflecting unequal opportunity—where markets and governments are working less well.

Again differences between Latin America and East Asia illustrate the point. In Latin America, by age 24, the children of the richest 20 per cent of households have about six more years of education than the children of the poorest 20 per cent; in East Asia the comparable gap is roughly 4.5 years. This is despite the fact that the Latin American countries shown (Table 1) have on average per capita incomes three times as high as those of the East Asian countries. In East Asia, public spending on basic education was higher, and the initial distribution of land helped ensure that more households had the assets to finance the opportunity cost of sending children to school and the incentives to demand adequate schooling.

If inequality in one form or another reduces growth, then it is implicated in reduced poverty reduction—since growth is necessary if not sufficient for reducing poverty, and since whatever growth occurs will help the poor less in an accounting sense the less equal the distribution of income (Ravallion 1997, 2001). There may also be a more substantive link of inequality to the persistence of poverty when some growth occurs. Birdsall and Londoño (1997) find that across countries, greater land and education inequality reduces the income growth of the poorest quintile about twice as much as they reduce average income growth for all quintiles. In the extreme, unequal distribution of land may cut off altogether the usual effect (in East Asia and elsewhere) of growth in agriculture on reduction of rural poverty. Some evidence

TABLE 1  
AVERAGE YEARS OF SCHOOLING BY WEALTH  
IN LATIN AMERICA AND EAST ASIA, 1996-2002

	Average years of schooling, 1996-2002 <sup>1, 2</sup>			Per capita income
	Poorest 20% of households	Richest 20% of households	Difference between poorest and richest 20% (years)	GDP per capita (constant US\$ 2000)
Colombia	2.4	9.8	7.4	1,970
Guatemala	2.0	8.9	6.9	1,680
Paraguay	4.9	9.6	4.7	1,400
Peru	5.0	9.8	4.8	2,080
Average, above four countries	3.6	9.5	6.0	1,780
Cambodia	2.4	7.4	5.0	300
Indonesia	6.7	10.8	4.1	760
Philippines	6.2	10.2	4.0	1,020
Vietnam	5.2	10.3	5.1	440
Average, above four countries	5.1	9.7	4.6	630

Notes: <sup>1</sup> Average years of formal schooling received by population aged 15-24 years;

<sup>2</sup> Data are for the latest year available during the period 1996-2002.

Source: World Bank (2006b) and World Bank (2006c).

suggests that agricultural growth in Latin America in the 1970s and 1980s failed to reduce poverty at all (de Janvry and Sadoulet 1993), as large landowners captured most of the benefits. In contrast, in Indonesia, where small farmers provide the bulk of agricultural production, growth was good for the rural poor even in the days of Sukarno and still better in the days of Suharto (Timmer 2006a, 2006b).

In short, in the real world beyond the textbook, inequality may inhibit growth—and especially so in developing countries where markets are not as competitive and governments are not as effective. Inequality matters because it tends to reduce growth in those very countries where the bulk of the world's poor—who would benefit from growth—live.

## **1.2 Inequality tends to undermine good public policy**

Behind the evidence that inequality inhibits growth is the likelihood that concentration of income and assets at the top not only interact with market failures to reduce growth, but also lead to government failure. Public-choice models attribute poor public policy to government regimes in which bureaucrats and insiders face no real checks on the pursuit of their own interests (Buchanan and Tollison 1984). If the rich favour public policy that preserves privileges even at the cost of growth, inequality not only inhibits growth given government failure, but contributes itself to government failure. The problem seems especially great when the concentration of income at the top is combined with substantial poverty at the bottom, and there is no large middle class to demand accountability from government.

Consider the apparent relationship between a high concentration of income in a society and access to education—keeping in mind for example the difference between East Asia and Latin America in educational opportunities for the poor. Supply of publicly subsidized education is likely to be limited where the rich resist a large tax burden to finance services they can purchase privately. Targeting services to the poor, an approach encouraged by the World Bank, can help reduce the fiscal burden of greater public spending, but easily leads to loss of political support from the working and middle class. Without middle class interest and pressure, schooling quality deteriorates, and the middle class resorts to private services. On the demand side, low public spending combined with pressure to maintain or expand enrolment leads to low-quality schools, reducing the economic returns to poor families of sending children to school who can otherwise help at home or by working. This may explain the high dropout rates throughout much of Latin America, even in the face of high returns on average to those who manage to complete secondary school (Behrman and Birdsall 1983).

Racial and ethnic discrimination in labour markets also implies lower average returns to education for some groups. Thus to the extent that income inequality reflects discrimination, a vicious circle of low education and persistent money inequality can result, even if the discrimination is acknowledged and officially discouraged and even if it is receding. This may well be happening in the US, Brazil, and South Africa. Demand for education among blacks would reasonably be lower because of past, if not current, discrimination, perpetuating current levels of income inequality by slowing the catch-up of education among blacks compared to whites.

### *The middle class and accountable government*

It is possible for income inequality to contribute to poor policy even where there is little or no absolute poverty. If large differences in income and wealth lead some people to ‘feel inferiority and shame at the way they must live’, then these people are likely to feel and be less politically active.<sup>15</sup> An extreme example are the untouchables, or scheduled castes, in India; even the nonpoor members of this group have not been able to use their potential political power to exploit fully what are aggressive quotas for government jobs and other forms of affirmative action (Darity and Nembhard 2000).

In many other settings where there is little absolute poverty (including most, if not all, advanced economies), relatively low income is combined with racial or ethnic minority status (in part reflecting past if not current discrimination), and with a weak political voice. Though it is not clear whether minority status or relatively low income is the real culprit, income inequality probably compounds, if not causes, political weakness.

In the extreme, the political weakness of the relatively poor may mean that the advantaged exercise sufficient control over others to constitute an ‘abridgement of liberty’ (Beitz 1989). Sometimes that control occurs as a result of financial contributions to political campaigns, access to the media, or less benign exercises of political influence such as bribes and extortion. If these kinds of influence in turn affect job availability, workplace safety, or local environmental conditions, then large inequalities can be said to matter because of their political repercussions.

There may also be bad political outcomes when those who feel disadvantaged *do* have political voice. Because people care about inequality, inequality raises the likelihood of perverse policy responses—economic policies that make inequality worse while also inhibiting growth. Put another way, high inequality may generate

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<sup>15</sup> Thomas M. Scanlon, cited in Beitz (2001: 95-112).



not only inadequate social policy through perverse effects on political participation; it may also lead to positively perverse economic policies.

There are many examples. Populist programmes designed to attract the political support of the working class hurt workers in the long run—this was the case in Garcia’s Peru in the 1980s and Peron’s Argentina. When financed by unsustainable fiscal largesse, they bring the inflation or high interest rates that exacerbate inequality. (The rich can protect themselves from inflation with indexed financial assets and by placing capital abroad; and from high interest rates by pressing for privileged access to credit.) Price controls imposed on food products consumed by the urban middle class and the poor hurt rural producers, or they lead to the disappearance of products from stores as they are hoarded and resold at higher prices out of reach of the majority. A high minimum wage may make it harder for the unemployed to find work. High interest rates penalize the small business sector. Regulatory privileges, trade protection, and special access to cheap credit and foreign exchange—all bad economic policies—inevitably increase the profits of a wealthy minority.

It would be silly to blame all bad policy on income inequality, but it would also be foolish to ignore the risks of inequality to sound policy and the frustrations it produces. The reality, or the perception, of a growing gap between the middle and the rich is particularly fertile ground for the perverse choices mentioned above. The evidence is that the gap tends to be greater in developing compared to developed countries, and has grown in the last decade in the former socialist economies of Eastern Europe and Russia (Birdsall, Graham, and Pettinato 2000).

### **1.3 Inequality tends to inhibit effective collective decisionmaking**

Amartya Sen (1992) places considerable emphasis on individuals’ ‘capability’ to participate in the life of the community. Participation in the life of the community suggests there are assets that are held not individually but only in relation to others; Putnam (1993) defines the asset of social capital in terms of trusts, norms, and networks that can improve the efficiency of society, ‘facilitating coordinating actions’. Social capital has economic value because it is likely to reduce the cost of transactions and of contract enforcement and, as Rodrik (1993) points out, reduce resistance of the losing groups to political compromises.

There is good evidence from microeconomic analyses that income inequality adversely affects some of the inputs or correlates of social capital. In Tanzania, informal insurance is higher in communities where income inequality is lower (La Ferrara 2000). Among sugar cooperatives in India, where land ownership is

more unequal, cooperatives are less productive (Banerjee *et al.* 2001).<sup>16</sup> The literature on local public finance addresses the same issue indirectly, in assessments of the link between income levels and the formation of communities with different amounts of heterogeneity. A typical finding is that the quality of publicly provided education is inversely related to income inequality, controlling for average income (Fernandez and Rogerson 2003).

Finally there is the evidence from studies of crime and violence. Fajnzylber, Lederman, and Loayza (2002) assess the impact of inequality on homicide rates in a cross section of 39 countries over the period 1965-95. Income inequality measured by the Gini coefficient had a significant and positive effect on homicide rates, robust to a variety of specifications. Ratios of income of contiguous quintiles starting with the second quintile (that is, third to second, fourth to third, and fifth to fourth) exacerbate crime, and at an increasing rate. In other words, it was neither poverty nor inequality at the bottom that explained crime, but the disparity between the middle strata and their richer counterparts. It was not absolute but relative income that mattered.

## **PART II**

### **GLOBALIZATION IS DISEQUALIZING**

A fundamental challenge posed by the increasing reach of global markets ('globalization') is that global markets are inherently disequalizing, making rising inequality within developing countries more rather than less likely. To the extent inequality reduces growth prospects of developing countries, given capital market failures and given its potential perverse effects on policymaking and social capital, a disequalizing effect of globalization within developing countries is a development issue. Before elaborating on why and how globalization is inherently disequalizing, I review what we know about changes in inequality over the last two decades.

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<sup>16</sup> In the United States the percentage of households that participate in various membership organizations is higher in metropolitan areas with lower income inequality—controlling for racial and ethnic heterogeneity, income, education, and other household characteristics. The effect is substantial. An increase in the Gini coefficient of inequality by one standard deviation leads to a reduction in the probability of participation of 24 percentage points—more than two times the effect on participation of an individual going from the status of highschool dropout to highschool graduate or beyond (Alesina and La Ferrara 2000).

## 2.1 Recent trends of global inequality

Global inequality measured across countries and across individuals irrespective of where they live (that is, just lining up all individuals in the world from poorest to richest) is extraordinarily high—higher than measured inequality within Brazil and South Africa, the highest inequality countries in the world. That is mostly because of the enormous difference in the average income of the richest compared to the poorest countries—a ‘divergence big time’ (Pritchett 1997) that has grown from perhaps 9 or 10 to 1 in 1900 to 100 to 1 today. However in the last several decades, the decades of increasing integration of markets, inequality across individuals has probably begun to level off—mostly because rapid economic growth in China, India, and other large and poor countries of South Asia has moved millions of people out of poverty, shifting a large enough portion of the world’s individuals from the poorest to less poor parts of the overall world income distribution. In other words, the beneficent effects of growth in some large and poor countries on poverty reduction have also meant a reduction across individuals in inequality. The success of these countries is justifiably invoked by proponents of globalization. It is countries that have successfully entered the global market which have grown most.<sup>17</sup>

At the same time the picture is different across countries and within countries. Across countries, and particularly between the richest and the poorest countries, inequality continues to grow simply because of a continuing difference in the rates of growth of the most successful advanced economies compared to the least successful and thus now poorest economies. Today’s rich countries—of Europe, North America, and Australia, which were already richer 100 years ago primarily because of the Industrial Revolution—are continuing to grow in per capita terms, and continuing therefore to get richer. Today’s poorest countries, many in Africa, are poor in part because they have grown little at all in per capita terms (Table 3). Some developing countries—China, India, Botswana, Chile—are now growing faster in per capita terms than some advanced economies. Some in the past—Brazil, Korea—grew faster. So convergence is possible. But by definition some of the currently poorest countries are very poor because they have failed to grow; so divergence between them and the richer and richest

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<sup>17</sup> Among those invoking these countries’ recent success are Wolf (2004); Bhagwati (2004); Sala-i-Martin (2002); Bhalla (2002). In the past, successful countries benefiting from globalization have included Japan, beginning in the Meiji era between 1868 and 1912; the poorer countries of Western Europe during the nineteenth century and then again during the post Second World War period of European integration; and among the developing world in the postwar era, the so-called miracle economies of East Asia in the three decades before the 1997 financial crisis. More recently, it has included China, India, and in addition Bangladesh, Brazil, Malaysia, Mexico, Mozambique, the Philippines, Thailand, Uganda, and Vietnam. Poverty remains highest in the countries (and regions) and for peoples that are marginal to global markets, including many in Africa, some in South Asia, and among people, the rural populations of China, India, and Latin America. To the extent that globalization has ‘caused’ increasing inequality, it is not because some have benefited a lot—a good thing—but because others have been left out of the process altogether.

countries has increased. The problem of divergence can be thought of in terms of the conventional challenge of triggering sustainable growth and development transformation in today's poorest countries—but today in a world where a more integrated global economy is raising the bar of competitiveness.

Within many developing countries, moreover, the evidence is that where inequality is not already high—posing the kind of problems outlined in Part I—it is rising. In the last two decades, income inequality increased in China, where phenomenal income growth has been heavily concentrated in urban areas (in a pattern Kuznets (1955) foretold decades ago); in most countries of Eastern Europe and the former Soviet Union, where growth has been minimal and the current poor are worse off than they were before the fall of communism; and in Mexico, Panama, and Peru in Latin America, where it rose during the low-growth years of the 1980s and failed to decline with the return to modest growth in the 1990s. Figure 5 shows the large rise in manufacturing pay inequality for some Eastern European and Latin American countries since 1980. Inequality is probably rising in India, though that is still controversial and to the extent it is the case, as in China, it is the result of a good thing—the new prosperity liberalization has brought to some.

It would be an exaggeration to say that rising inequality within countries has been the norm. In some developing countries, income inequality has simply not changed, and in a few, including Japan, Canada, and Italy among the industrialized countries, and Bangladesh, Ghana, and the Philippines, it appears to have declined. Nor does it make sense to 'blame' globalization and see some inevitable tradeoff between growth and inequality in countries like China and India. The issue is different: To the extent global integration creates pressures that tend to increase inequality, it is worth understanding what those pressures are, how they operate, and how they might best be managed, within countries and at the global level.

Similarly, in the case of the poorest countries that seem unable to exploit the potential of globalization, it is worth understanding whether they are worse off because of the competitive pressures that they face in the more integrated global economy, rather than better off as has generally been assumed because they can exploit the technologies others have developed to catch up.

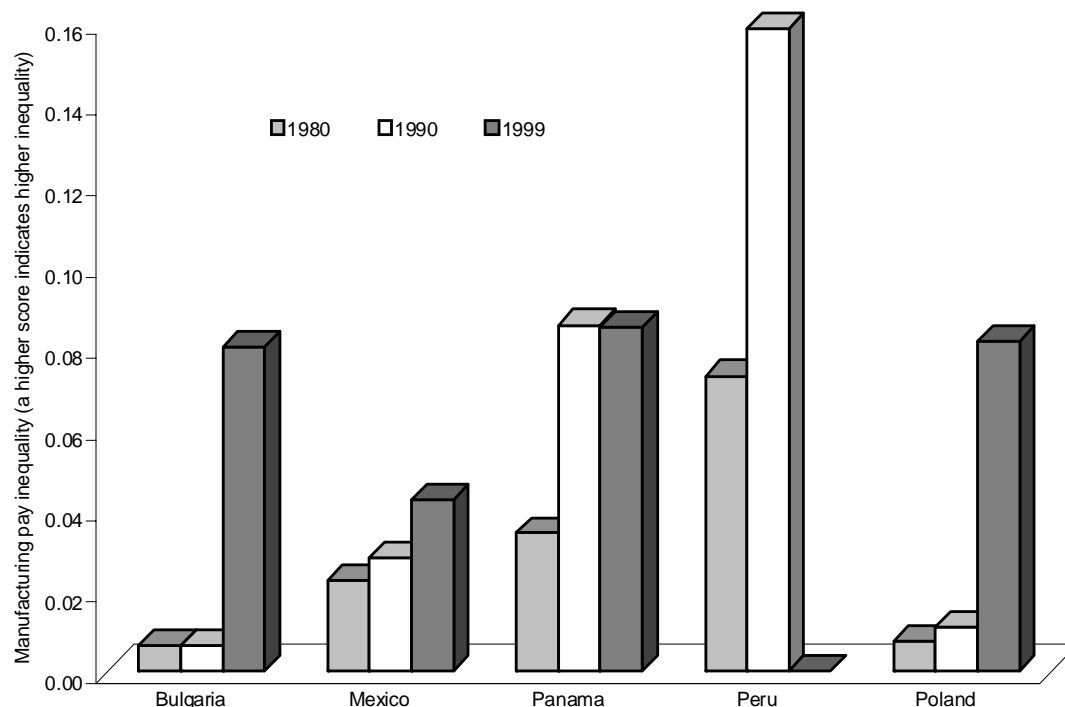
TABLE 2  
ANNUAL GDP PER CAPITA GROWTH RATES BY REGION, 1980-2003

	Average annual real GDP per capita growth rates, 1980-2003		
	Mean	Median	Share of total with negative growth rate <sup>4</sup>
High-income OECD countries <sup>1</sup>	2.2	1.8	0%
Middle-income countries <sup>1</sup>	1.1	0.9	23%
Low-income countries <sup>1,2</sup>	-0.3	-0.1	59%
Sub-Saharan Africa, low income <sup>1,3</sup>	-0.5	-0.2	67%
China	8.2	n/a	n/a
India	3.7	n/a	n/a

Notes: <sup>1</sup> World Bank definitions based on countries' per capita income at the end of the period;  
<sup>2</sup> Low-income countries exclude China and India;  
<sup>3</sup> There is some overlap between the categories 'low-income countries' and 'Sub-Saharan Africa, low income';  
<sup>4</sup> These are the countries with negative GDP per capita growth rates as a percentage share of the total number of countries in their relevant group.

Source: World Bank (2006b) and author's calculations.

FIGURE 5  
UTIP-UNIDO WAGE INEQUALITY (THEIL INDEX) FOR SELECT COUNTRIES, 1980-99



Source: UTIP (2006).

## 2.2 Disequalizing globalization: three reasons

Consider three reasons why the global economy tends to sustain or worsen current money inequality—across countries and in particular within developing countries.

- Global markets reward more fully those countries and individuals with more of the most productive assets. (Call this, for simplicity, the market works.<sup>18</sup>)
- In the global economy, negative externalities raise new costs for the vulnerable and compound the risks faced by the already weak and disadvantaged. (Call this, for simplicity, the market fails.)
- In the global economy, existing rules tend to benefit most those countries and individuals who already have economic power; it is natural that the richer and more powerful manage to influence the design and implementation of global rules—even those rules meant to constrain them—to their own advantage.

### *The market works: global markets reward productive assets*

Globalization is shorthand for global capitalism and the extension of global markets. Markets that are bigger and deeper reward more efficiently those who already have productive assets: financial assets, land, physical assets, and perhaps most crucial in the technologically-driven global economy, human capital.

For countries, the key productive asset seems to be stable and sound institutions. Countries that are already ahead—with stable political systems, secure property rights, adequate banking supervision, reasonable public services, and so on—are better able to cope with market-driven changes in world prices.<sup>19</sup> Consider the plight of a large group of the poorest countries, including Bolivia and many in Africa. Highly dependent on primary commodity and natural resource exports in the early 1980s, their markets have been ‘open’ for at least two decades, if openness is measured by their ratio of imports and exports to GDP. But unable to diversify into manufacturing (despite reducing their own import tariffs) they have been victims of the decline in the relative world prices of their commodity exports, and have, literally, been left behind.<sup>20</sup> (See Figures 6 and 7.) These countries have not been

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<sup>18</sup> This is also true, of course, at the country level. Of course markets do not work perfectly; there are market failures, which I come to next. But in general markets do reward those with productive assets more than those without those assets.

<sup>19</sup> Azariadis and Stachurski (2005) provide an extensive review in the context of institutional poverty traps.

<sup>20</sup> Birdsall and Hamoudi (2002) argue that the use of the trade/GDP ratio to represent policy openness is misleading as many of Dollar and Kraay’s (2001) ‘non-globalizers’ are commodity-dependent exporters with limited import protection. Though the policies of these countries could be better from the point of view of growth, their institutional problems may well be at the heart of their policy deficiencies. In

xenophobic or in any way closed to the global economy. But despite rising exports, tariff reductions, and, in most of them, economic and structural reforms including greater fiscal and monetary discipline and the divestiture of unproductive state enterprises, they have been unable to increase their export income, have failed to attract foreign investment, and have grown little, if at all.<sup>21</sup>

Many of these countries in Sub-Saharan Africa, as well as Haiti, Nepal, and Nicaragua, seem trapped in a vicious circle of low or unstable export revenue, weak and sometimes predatory government, inability to cope with terrible disease burdens (the HIV/AIDS pandemic being only one recent and highly visible example), and failure to deliver the basic education and other services to their children that are critical to sustainable growth. Their governments have made, from time to time, fragile efforts to end corruption, to undertake economic reforms, and, more to the point, to enter global markets. But, caught in one variety or another of a poverty trap, ‘globalization’ has not worked for them. For these countries, success in global markets might be a future outcome of success with growth and development itself, but does not seem to be a key input.

In contrast, countries that discovered their natural resources already having the ‘asset’ of strong political and social institutions (e.g, Australia, Norway, and among developing countries Chile and Botswana) have not suffered the same problems. In a similar vein, Easterly (2004) argues persuasively that in the new global economy, we should not expect the convergence between rich and poor countries that the conventional factor endowment model predicts—in which capital and other factors move to where they are scarce and their return is thus highest. That model famously predicts that trade will reduce inequality within the developing countries by raising the wages of plentiful unskilled labour. Easterly (2004) notes that in today’s globalization era, the evidence contradicts the theory,<sup>22</sup> and suggests instead that existing productivity differences across countries make ‘capital’ and ‘skilled labour’ economically scarcer in high-productivity settings, explaining why skilled people move to those settings where their counterparts are plentiful. This also explains why 80 per cent of all foreign investment occurs among the industrialized countries (and just 0.1 per cent of all US foreign investment went to Sub-Saharan Africa last year) (UNCTAD 2001). The productivity differences arise, presumably, because of longstanding differences in physical infrastructure and human capital, themselves the product of the incentives inherent in environments created by differences in the nature of social and political institutions.

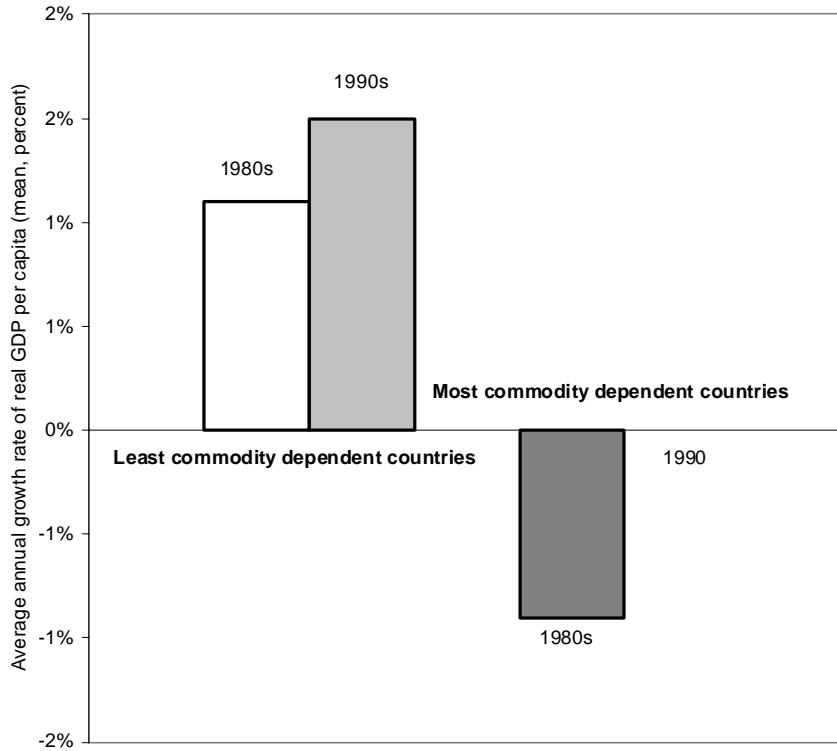
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Birdsall (2005), I note that a country may reduce its tariffs but still suffer the costs of chicanery at the border by customs officials—the latter being as much an institutional challenge as a policy challenge.

<sup>21</sup> The problems of these countries have often been compounded by the concentrations of wealth and the internal conflicts over control of their natural resources to which they seem so prone. Of course, there are many possible reasons for stalled growth; in many commodity-dependent countries: poor governance, civil conflicts, high disease burdens and bad geography.

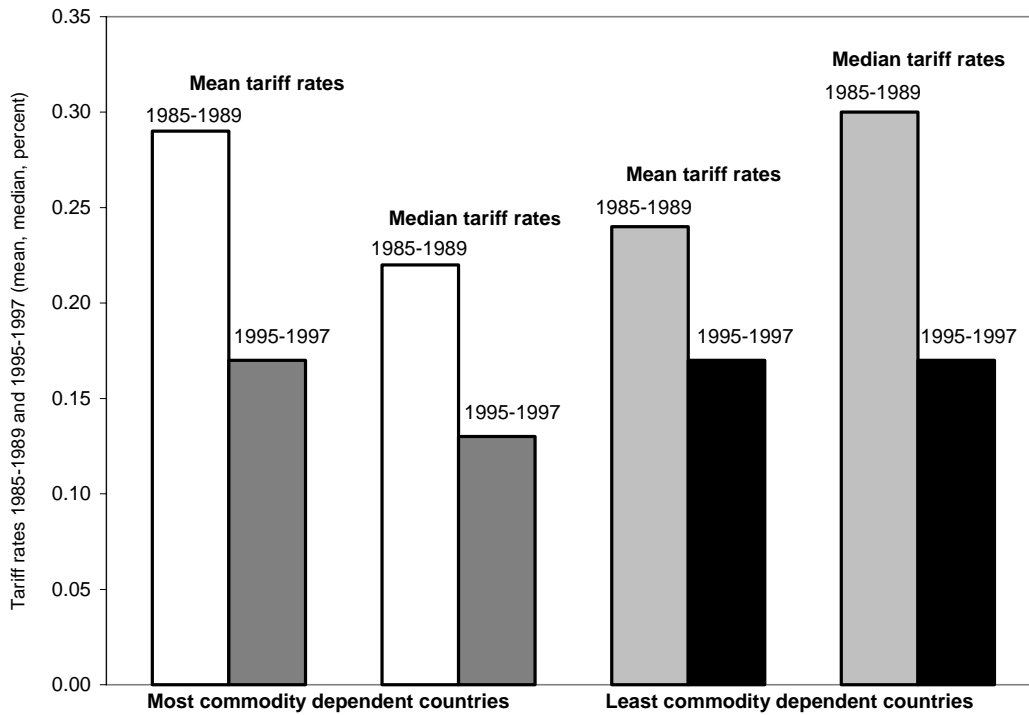
<sup>22</sup> And see, among many others, Lindert and Williamson (2001); Stiglitz (2002); and Wade (2004).

**FIGURE 6**  
**THE GLOBAL MARKET DOES NOT REWARD THE WRONG ASSETS: OPEN, GLOBALIZING COUNTRIES HEAVILY DEPENDENT ON COMMODITY PRICES HAVE NOT GROWN**



Source: Birdsall and Hamoudi (2002).

**FIGURE 7**  
**OPEN, GLOBALIZING COUNTRIES HEAVILY DEPENDENT ON COMMODITY PRICES HAVE NOT GROWN, DESPITE HAVING COMPARABLE TARIFF RATES TO OTHER COUNTRIES**



Source: Birdsall and Hamoudi (2002).



FIGURE 8  
EMIGRATION RATES TO ALL OECD COUNTRIES BY EDUCATION LEVEL, 2000

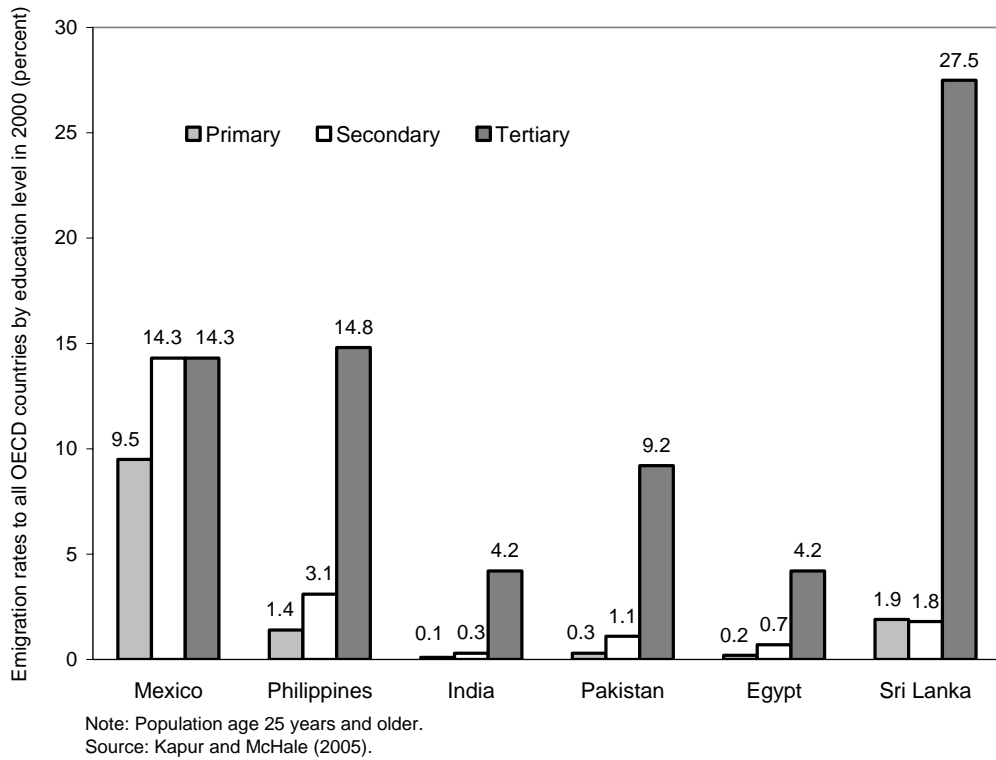
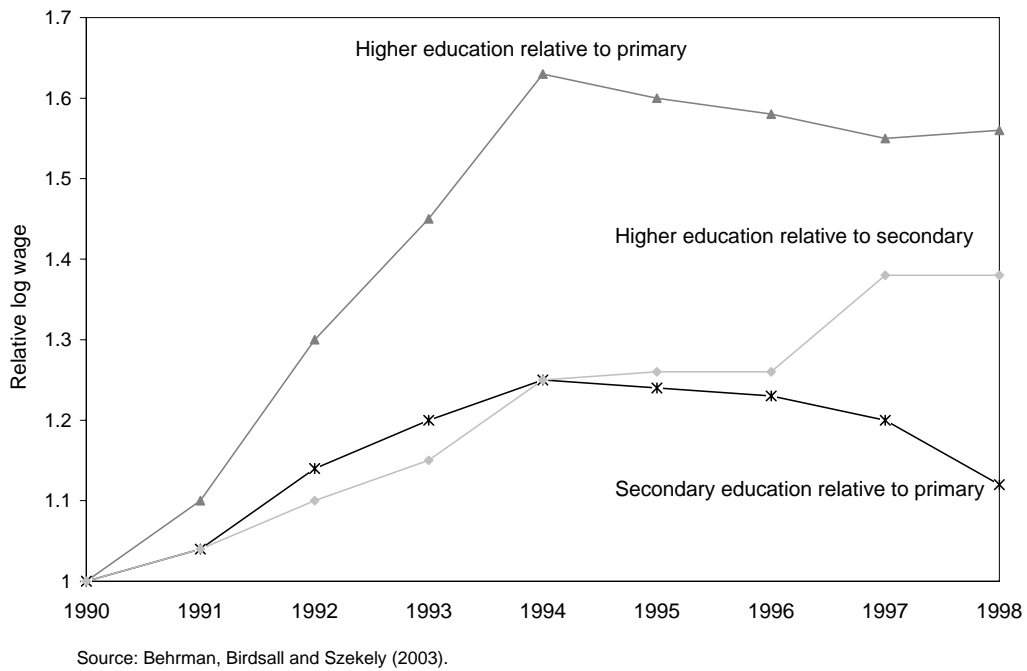


FIGURE 9  
RELATIVE RETURNS TO EDUCATION IN LATIN AMERICA



The global market for skilled and talented people is a good example of the general tendency for markets to benefit most the already strong—individuals as well as countries. In today's global economy the advanced economies are now competing with each other in encouraging immigration of the highly skilled (Kapur and McHale 2005). As a result, it is those with the most education and skills that are more likely to emigrate from developing countries (Figure 8). Indian engineers can quadruple their earnings by moving from Kerala to Silicon Valley and Indian PhD biochemists from Delhi to Atlanta or Cambridge. More integrated markets thus increase inequality across countries, via emigration from smaller and poorer countries of highly skilled citizens, who naturally are most likely to leave the countries where they are least able to deploy their skills productively.<sup>23</sup>

For the individuals who emigrate, their mobility is a good thing, and this braindrain can generate offsetting remittances that raise welfare in the sending countries. It can also generate substantial return investments if the institutional and policy setting in their home countries improves, as has been the case in India recently (Kapur and McHale 2005). At the same time, however, it makes the task of poorer countries, trying to build those institutions and improve those policies, tougher. The annual loss to India of its braindrain to the US is estimated at US\$2 billion, about equal to all the foreign aid it receives (UNDP 2001). The farmers and workers whose taxes finance education in poor countries are subsidizing the citizens of the rich countries—whose tax revenues are boosted by the immigrants' contributions (and whose cultures, by the way, are also greatly enriched).

Indeed, the braindrain issue illustrates well the fundamental reality that today's globalization can involve at least a short-term tradeoff for poorer countries—even those like India that are growing rapidly. Emigration of its skilled people can bring benefits, but only under certain circumstances. At the same time, it is likely to increase inequality within countries—because the relative wages of those with increasingly scarce skills rise as their skilled counterparts emigrate. That creates political pressures (as in India today) and can even backfire economically, if the rapid rise in wages undermines competitiveness. (On the latter, see Kochhar *et al.* 2006.)

That brings us to the implications of global markets for inequality among individuals within countries. At the individual level, the best example of how healthy markets can generate unequal opportunities is the rising gap in earnings between those with and those without higher education. The effect of having a university education compared to secondary education or less has been increasing for years everywhere. Figure 9 shows the increase in returns to some higher

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<sup>23</sup> The emigration of nurses from Sub-Saharan Africa has been widely decried, but Michael Clemens' analysis (forthcoming) suggests that the loss to sending countries needs to be discounted by the likelihood that the emigrants were unable to be very productive at home due to the institutional, infrastructural, and management problems of the country health systems they leave.

education compared to some secondary and some primary education estimated on the basis of wage changes by schooling for 18 countries of Latin America.

The relative return to higher education has been rising despite the fact that more and more people are going to university, including across the developing world. More integrated trade markets, capital flows, and global technology, including the internet, are increasing the worldwide demand for skills more rapidly than the supply, despite increasing enrolments. In the US the highly educated have enjoyed healthy earnings gains for three decades, while those with highschool education or less have suffered absolute wage losses. In Eastern Europe, with the fall of communism, the wage difference between those with and without post-secondary education has widened considerably.<sup>24</sup> Just about everywhere in the world (Cuba, China, Kerala state in India, all socialist entities, being exceptions), education is reinforcing initial advantages instead of compensating for initial handicaps.

Rising wage gaps in open and competitive markets may be a short-term price worth paying for higher long-run sustainable growth. They create the right incentives for more people to acquire more education, in principle eventually reducing inequality. The same can be said for the development of institutions at the country level. Many poor countries have responded to global opportunities by strengthening the rule of law, building and strengthening democratic processes, and investing in public health and education. But just as to educate their children poor families need resources to compensate for initially unequal endowments and the incentive that equal opportunity provides, so to build better institutions poor countries need resources and the incentive that at least a level global playing field provides.

The efficiency gains and increased potential for growth of a global market economy are not to be disdained. But even when participation in the global market brings growth, as in China and India, it is a mixed blessing, bringing political pressures for populist measures and, especially if growth falters, for protectionism. Even Europe and the US are subject to those pressures—but with more resilient institutions and well-developed social insurance programmes they can better afford temporary policy errors. The political risks are greater still when engagement in global markets fails to bring growth, as in Latin America and much of Sub-Saharan Africa. The domestic reforms that are key to growth in a global economy are (ironically) resisted. Part of the resistance is due to the fear of job loss, in turn a product of less flexible labour and financial markets in most developing countries (and the comparison of Europe to the US is also apt here with respect to labour markets), and part due to the inadequacy of social safety nets to minimize the welfare effects of job loss and other shocks to household income.

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<sup>24</sup> For more on the United States, see Levy (1999); on Latin America see Duryea and Székely (1998); on Eastern Europe see Terrell (2000); on Mexico author's calculations.

In short, because global markets work well, they tend to increase inequality between rich and poor countries and individuals. Countries caught in an ‘institutional poverty trap’ will not necessarily benefit from a healthy global market. Within and across countries, individuals who begin life with lesser endowments—by reason of poverty, discrimination, lack of educational and other opportunities—tend to lose out relative to the better-endowed.

*The market fails: in the global economy, negative externalities hurt most the already weak*

A second reason why globalization is disequalizing is that global markets are far from perfect. They fail in many domains. The classic example of a market failure is that of pollution, where the polluter captures the benefits of polluting without paying the full costs. At the global level, the rich countries that have emitted the highest per capita greenhouse gas emissions have imposed future costs on poor countries—who have fewer resources to manage or mitigate the effects. As the biggest polluter in per capita terms, the US is imposing costs not only on its own future citizens, but also on the children and grandchildren of the world’s poor, who will be particularly vulnerable.

Similarly with global financial crises. The financial crises of the late 1990s that affected Mexico, Thailand, Korea, Russia, Brazil, and Argentina were in part due to policy errors in those countries. But a healthy portion can be blamed on the panic that periodically plagues all financial markets. In East Asia, accumulation of high reserves for self-insurance against future crises has been one reaction; the costs of maintaining high dollar reserves (given the low interest rates received compared to potential returns domestically) represent a perverse transfer from the developing world to the US.<sup>25</sup> In Brazil public sector debt, already high, grew again (due to borrowing) when its markets were attacked in 2002, keeping interest rates high and job and investment growth lower than otherwise.

The problem the emerging market economies of Latin America and East Asia face in global financial markets has not only brought instability and reduced growth; it has affected their capacity to develop and sustain the institutions and programmes they need to protect their own poor. In Korea, Mexico, and Thailand, financial crises reduced the income shares of the bottom 80 per cent of households compared to the top 20 per cent (Table 4). During the accompanying recession in Mexico in 1995, many children of the poor dropped out of school—and subsequent studies show that many never returned (e.g., Székely 1999).

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<sup>25</sup> Summers (2006) discusses the anomaly. See also Stiglitz (2002).

TABLE 3  
FINANCIAL CRISES AND CHANGES IN INCOME SHARES IN EAST ASIA AND LATIN AMERICA

	Pre-crisis		Post-crisis	
	Income share <i>poorest 80%</i> of population (%)	Income share <i>richest 20%</i> of population (%)	Income share <i>poorest 80%</i> of population (%)	Income share <i>richest 20%</i> of population (%)
Korea	61.2	38.8	58.3	41.7
Philippines	48.0	51.9	45.2	54.8
Thailand	39.2	60.8	38.2	61.8
Brazil	35.1	64.8	34.4	65.6
Mexico	42.0	58.0	41.5	58.5
	Income share <i>poorest 40%</i> of population (%)	Income share <i>richest 20%</i> of population (%)	Income share <i>poorest 40%</i> of population (%)	Income share <i>richest 20%</i> of population (%)
Korea	19.3	38.8	15.9	41.7
Philippines	13.7	51.9	12.3	54.8
Thailand	8.2	60.8	7.8	61.8
Brazil	8.2	64.8	8.0	65.6
Mexico	11.2	58.0	10.7	58.5

Notes: East Asian financial crises 1997/8, Brazil crisis 1999, and Mexico crisis 1994/5.

Pre-crisis data for Thailand, Korea, and Brazil are from 1996, for the Philippines from 1994 and Mexico 1992. Post-crises data are from 1996 for Mexico, 1998 for Korea, 1999 for Thailand, 2000 for the Philippines, and 2001 for Brazil.

Source: WIDER WIID 2.0a (2005) and author's calculations. Reproduced from Birdsall (2006).

The volatility and financial risks that come with participation in global markets tend to be disequalizing over the long run within countries. Analysis by Lundberg and Squire (2003) indicates that negative terms of trade shocks hurt lower quintiles of the income distribution disproportionately. That should not be a surprise. Birdsall and Hamoudi (2002), Lustig (2000), and the World Bank (2001) all find evidence that volatility, whatever its source, is particularly bad for the poor. The biggest culprit, however, seems to be the premature opening of capital markets, which are particularly implicated in volatility in developing countries, with limited if any benefits in terms of higher growth (Prasad *et al.* 2004), a point acknowledged by the International Monetary Fund in its 2002 *World Economic Outlook*.

Premature opening of the capital market—before adequate banking supervision and financial regulation are in place—brings pressures for increased inequality along with volatility, for at least two reasons. One is a function of being a ‘developing’ or ‘emerging’ market. With global market players doubting the commitment of non-industrialized countries to fiscal rectitude at the time of any shock, countries are forced to resort to tight fiscal and monetary policy to reestablish market confidence,

just when in the face of recession they would ideally implement macroeconomic measures to stimulate their economies. The (procyclical) austerity policies that the global capital market demands of emerging markets are the opposite of what the industrial economies implement, such as reduced interest rates, unemployment insurance, increased availability of food stamps, and public works employment: fundamental ingredients of a modern social contract. The effects of unemployment and bankruptcy can be permanent for the poor, so that repeated shocks constitute a structural factor in increasing inequality.<sup>26</sup>

Second, the bank bailouts that follow crises generate high public debt (amounting to 10 to 40 per cent of annual GDP compared to 2-3 per cent on average in advanced economics, for example, World Bank 1998/9: 126). High public debt keeps domestic interest rates high, stifling investment, growth, and job creation—all bad for the poor—and increases the pressure on emerging market economies to generate primary fiscal surpluses, in the long run reducing their ability to finance sound broad-based investment in health and education—and their ability to spend more on the unemployment and safety net programmes that would protect the poor in bad times.<sup>27</sup>

The risks of global warming and the problems of global financial contagion are only two examples of market failures that entail asymmetric costs and risks for poor countries and, within developing countries, for their poor people.<sup>28</sup> The same can be said of contagious disease that crosses borders, and of a host of ‘policy’ and ‘regulatory’ failures associated with more open borders and more integrated markets such as increased transnational crime and sex trafficking (Naím 2005). In general, the ability to adjust to change, or to finance mitigation costs, is smaller for poorer countries, and within countries, for poorer people. In that sense these market failures have a tendency to contribute to increased inequality—between countries and within developing countries, where safety nets and the capacity for social, political, and economic adjustments to changing conditions is more limited.

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<sup>26</sup> Cross-country analysis of the respective losses to capital compared to labour during crises suggests that labour loses more and recovers less, with the same implication. See Diwan (2001).

<sup>27</sup> Dervis and Birdsall (2006) discuss this problem and propose a special international facility—a stability and social investment facility—to help high-debt emerging economies better manage the effects on their ability to address the needs of their poor.

<sup>28</sup> Similarly, poor countries that protect global resources such as tropical forests and biological diversity are paying the full costs but are unable to capture the full benefits of these global goods.

*Global rules and regimes tend to favour the already rich—countries and people*

Finally, global markets tend to be disequalizing because trade, intellectual property, and migration regimes at the global level naturally reflect the greater market power of the rich.

Today's battle to reduce rich country agricultural subsidies and tariffs that discriminate against poor countries is a good example. The problem arises not because of any conspiracy but because domestic politics in Europe, the US, and Japan, as perverse as they are even for those countries themselves, matter more at the negotiating table than unequal opportunities for cotton farmers in West Africa.<sup>29</sup>

What is true of the design of multilateral rules is also true of implementation. In 2003 developing countries finally got clarity on their right to issue compulsory licenses to import as well as produce generic (rather than expensive patented) medicines during public health emergencies. But the rules for exercising that right to import are complicated, and many countries eager to maintain or improve their access to the huge US market for their own exports are acceding to WTO 'plus' patent protection, in effect giving up those rights, in bilateral trade with the US.

In the WTO and other multilateral settings, the cost and complexity of negotiation and dispute resolution processes put poor and small countries with limited resources at a disadvantage. An example is anti-dumping actions brought by US producers, even when they are unlikely to win a dispute on its merits. These create legal and other costs to current producers in developing countries, and are likely to chill new job-creating investment in sensitive sectors. About one-half of anti-dumping actions are initiated against developing country producers, who account for 8 per cent of all exports.<sup>30</sup>

International migration is governed by rules that clearly exacerbate inequality between the richest and poorest—countries and individuals. Permanent migration is small relative to the past because today higher-income countries restrict immigration (Kapur and McHale 2005). In the last 25 years, only 2 per cent of the world's people have changed their permanent country residence, compared to 10 per cent in the 25 years before the First World War (Dollar and Kraay 2002). Yet more movement, especially of less-skilled workers, would reduce world inequality considerably, as did the tremendous movements of Europeans to the Americas in the nineteenth century (O'Rourke and Williams 1999). An auto mechanic from

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<sup>29</sup> Cline (2004) concludes that as many as 400 million poor in the developing world could be lifted out of poverty if rich countries fully opened their markets. Rodrik (2005) outlines the limitations of the Doha round of trade negotiations as a 'development' round—suggesting whatever gains Doha produces for developing countries will have limited effects. Birdsall, Rodrik, and Subramanian (2005) emphasize the limits of trade liberalization alone for reducing poverty.

<sup>30</sup> Author's calculations based on World Trade Analyser and Finger and Schuknecht (1999).

Ghana can at least quintuple his income, just by moving from Ghana to Italy; as can a Nicaraguan agricultural worker, by moving to Arizona.

As discussed above, the rich countries actively encourage immigration of the highly skilled. During the recent boom in the information technology sector, the US established a special programme to allow highly skilled workers to enter with temporary visas—a good thing, of course, for the individual beneficiaries. The irony is that movement of the highly skilled into the more advanced economies probably reduces inequality within those economies, all other things the same, but increases inequality in the sending countries. In the sending countries, it increases the wages of the highly skilled that stay, and implies a tax on the working taxpayers in poorer countries who helped finance the education of the emigrants.

Economic power also affects the rules and the conduct of those rules by the international institutions. The International Monetary Fund is the world's institution meant to help countries manage macroeconomic imbalances and minimize the risks of financial shocks. But in the 1990s, the IMF was more enthusiastic about developing countries' opening their capital accounts than subsequent evidence about the costs warranted. This is one example where the IMF and the World Bank have been insufficiently humble in their recipes, perhaps too heavily influenced by their more powerful members. Another is their indiscriminate support for adjustment programmes that in some countries, though technically sound on paper, worsened the situation of the poor (for example maize farmers in southern Mexico) and exacerbated existing inequalities (as did financial sector liberalization and the opening of capital markets in Latin America)<sup>31</sup> because transition costs were inadequately considered and safety net programmes underfunded. Even if most of the policies supported make sense—and for the most part they do—the ability of enlightened leaders to implement them has been reduced because their international sponsors lack legitimacy—as Kemal Dervis (2005) nicely illustrates based on his personal experience as Minister of Economy in Turkey. The risks to their effectiveness as well as legitimacy are contributing to growing pressure for greater representation of the developing countries in the governance of these international institutions.<sup>32</sup>

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<sup>31</sup> Behrman, Birdsall, and Székely (2003) report that structural reforms, particularly capital market opening and financial sector liberalization increased inequality of wages between the highly educated and less education in Latin America in the 1990s, at least temporarily. Morley (2001) disagrees on which reforms mattered, but does report increasing inequality.

<sup>32</sup> Rodrigo Rato, the Managing Director of the IMF, has proposed changes in quotas to give the Asian countries greater representation, fearing the IMF will lose relevance in that part of the world. On the World Bank, see Birdsall (2006); and Woods (2006). See also Nayyar (2002) for a critical evaluation of the UN, the IMF, the World Bank, and the WTO.



## CONCLUSION: MANAGING GLOBALIZATION

Inequality within developing countries interacts with their weaker capital markets and institutions to stall growth, encourage perverse economic and social policies, and, in a potential vicious circle, inhibit the creation and strengthening of effective social and political institutions. The global market economy adds to the challenge. Though not the root cause of global inequality it does tend to exacerbate inequality all other things being the same—within developing countries and between rich and poor countries as well. The resulting inequality within and across countries is a development issue. What can be done about the resulting challenge to global security, stability, shared prosperity, and most fundamentally to global social justice?

### 3.1 A global social contract

In the advanced market economies there is a well-defined social contract that tempers the excess inequalities of income and opportunity that efficient markets naturally generate. Progressive tax systems provide for some redistribution, with the state financing at least minimal educational opportunities for all and some social and old age insurance. The social contract is less well developed in developing countries, almost by definition since they are ‘developing’. Yet the economic reforms that competitiveness in global markets requires, and the risks to economic stability it brings, tend to exacerbate existing market-based inequality, generating political pressure for populist redistribution. There is a sense in which the political leadership in many developing countries must manage a delicate balance between undertaking the structural reforms that will generate growth, and minimizing the short-term political risks that it often entails.

Politics is local, and the politics of inequality is doubly so. One lesson for the international community is to do no harm. Volumes have and will be written about the effects of donors’ efforts to use conditionality (the ‘policy’ conditionality of the 1980s and 1990s, and now today’s ‘process’ conditionality). Scepticism and humility about changing politics and policy from the outside seem warranted now. At the same time, in terms of actual resource transfers, the international community has yet to go beyond the shadow of any ‘global social contract’. Because global markets work better for the already rich (for individuals with higher education and for countries with stable and sound institutions), the international community needs something closer to a global social contract to address unequal endowments—to rapidly ramp up educational opportunities for the poor in developing countries, and to find ways to help societies build their own sound institutions. Spending by the rich world on the ‘global social contract’, now reflected in the idea of the Millennium Development Goals, is less than 1 per cent of rich country GDP. That is surprisingly low compared to the typical 20 per cent spent on public transfers for

education and social insurance within rich countries. It is a relevant comparison to the extent we now have a more and more integrated global economy—creating legitimate new demands for more shared prosperity.

The business of foreign aid is more effective and sensible than in the Cold War era, but that business itself needs to be reinvented if it is to become reasonably effective—with a premium on the financing of global public goods such as agricultural research and development, on results or output-based transfers, and on systematic evaluation.<sup>33</sup> At the same time, the need to do better should not be an excuse for the rich countries' minimal spending on foreign aid.

Most important, the global and regional institutions we have that are the world's most obvious mechanisms for managing a global social contract need to be reformed. It is ironic that the World Bank and the IMF have been the lightning rod for anti-globalization protests. It may be not that they are too powerful but too ineffective and limited in their resources. To play their role in managing a global social contract they need to become more representative and accountable to those most affected by their programmes, and thus more effective.

### **3.2 Addressing global market failures**

Within countries, governments are meant to temper market failures through regulations, taxes and subsidies, and fines, and to share the benefits of such public goods as public security, military defence, management of natural disasters, and public health through their tax and expenditure decisions. Ideally the latter are made in a democratic system with fair and legitimate representation of all people, independent of their wealth. At the global level, for the global community, an equivalent system to manage global market failures only barely exists.

Because global markets are imperfect, we need global regulatory arrangements and rules to manage the global environment (Kyoto and beyond), help emerging markets cope with global financial risks (the IMF and beyond), and ways to discourage corruption and other anti-competitive processes (a global anti-trust agency for example, as suggested by Bardhan, 2004). Global agreements on bankruptcy procedures, on reducing greenhouse gas emissions, on protecting biodiversity and marine resources, on funding food safety and monitoring public health are all development programmes in one form or another—because they reduce the risks and costs of global spillovers and enhance their potential benefits for the poor.

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<sup>33</sup> For examples of the debate and evidence about aid and its effectiveness, see the website of the Center for Global Development ([www.cgdev.org](http://www.cgdev.org)), and links therein.

Similarly with the provision of global public goods—the returns to spending on global public goods that benefit the poor have been extraordinarily high. This is the case of tropical agricultural research, public health research and disease control, and the limited global efforts to protect regional and global environmental resources. These global programmes need to be financed by something that mimics taxes within national economies. Proposals for a tax on international aviation or on carbon emissions fall squarely into this category, and might be more attractive (even in the anti-tax US) were they to be used to increase provision of such global public goods.<sup>34</sup>

### **3.3 Just global rules and full and fair implementation**

Within the advanced market economies, democratic politics help temper the inevitable tendency for the rich and powerful to set the rules to their own short-term advantage. At the global level there is no equivalent global polity—only the hope that the rich world will resist short-term advantages in favour of its long-term enlightened self-interest (provided at various times in the past by a benign hegemon—the Roman Empire, the British Empire, and the post-war American empire).

Reducing protection in rich country markets belongs on the agenda of all those fighting for global justice and the elimination of world poverty. Many developing countries are at an unfair disadvantage in global trade and other negotiations, and they need transfers from rich countries simply to effectively participate. This is especially the case for smaller and poorer countries.

Rich countries would do well to open their doors further to unskilled and not just skilled immigrants, allocating resources at home to ease the adjustment of native workers through job training. Even within political constraints, much more could be done by the rich countries in their own interests to make immigration regimes more sensible and more consistent with their overall policies in support of developing countries a part of their overall development policy. Sharing of tax receipts of skilled immigrants across sending and receiving countries is one example. Another is the effort to reduce the transaction costs of remittances. These could help offset the perverse effects of the brain drain on poor countries.

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34 In proposing innovative sources of funding for the Millennium Development Goals, Atkinson (2004) reviews, amongst others, global environmental taxes (such as a carbon tax) the taxation of currency transactions (the Tobin tax), a development-focused allocation of Special Drawing Rights by the IMF, the proposal for an International Finance Facility, a global lottery (or premium bond), and increased remittances by emigrants. As is apparent, some of these proposals are characterized by the double dividend of generating revenue while also promoting global public goods.

The global approach to intellectual property rights embedded in current WTO rules has struck the wrong balance between incentives for new research and public health needs.

In general the developing countries should be more fully and fairly represented in international institutions; this is especially the case in the international financial institutions, whose policies and programmes are so central to their development prospects. The same can be said for other international fora: the UN Security Council, the Basle Committee for Banking Regulation and Supervision, the G-8, and so on.

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We have a potentially powerful instrument to increase wealth and welfare: the global economy. But to complement and support that economy we have an inadequate and fragile global polity. A major challenge of the twenty-first century will be to strengthen and reform the institutions, rules, and customs by which nations and peoples complement the global market with collective management of the problems, including persistent and unjust inequality, which global markets alone will not resolve.

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