# Rising Inequality in the New Global Economy

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The world is becoming "flat" says Thomas Friedman, a New York Times columnist, in his new bestseller *The World Is Flat: A Brief History of the Twenty-first Century*. A globophile (an enthusiast of globalization), Friedman is urging the U.S. to take note of China and India's ability to compete on a new, Web-enabled global playing field. The U.S. needs to adjust to the new, flat world, one in which its longstanding technological and economic dominance is ending.

True: In the new global economy, the U.S. may no longer easily dominate. But the world is not, in fact, flat. Some entire countries and many people in many countries are stuck in deep craters that mar the global landscape. Those of us on the top, with the right education and in the right countries, can easily overlook the injustice and the frustrations they endure, and the problems they pose for the endurance and prosperity of the "flat" world.

The craters are real and deep. Global inequality across countries is high and rising. The U.S., Europe and Japan are now 100 times richer on average than Ethiopia, Haiti and Nepal, basically because the former have been growing for the last 100 years and the latter have not. That difference across countries was about 9 to 1 at the dawn of the 20th century. Rapid growth in India and China, two of the world's biggest and poorest countries, means inequality across the world's people is beginning to decline. But the decline is from astonishingly high levels. Differences in personal income (comparing the richest 10 percent of Americans to the poorest 10 percent of Ethiopians for example) are well above 10,000 to 1, not 100 to 1.

## Why Inequality Matters

Consider why high inequality matters, both within and across countries. It matters especially within developing countries, where people are more likely (and justifiably) to see in it signs of injustice, insider privilege, and unequal opportunity. They are often right. In developing countries inequality is usually economically destructive; it interacts with underdeveloped markets and ineffective government programs to slow growth – which in turn slows progress in reducing poverty. Economic theory suggests why: weak credit markets and inadequate public education mean only the rich can exploit investment opportunities. Middle income and poor households cannot borrow and miss out on potentially high returns on their own farms and small business ventures for example – often higher returns than the rich are getting on their capital. The most able children of the less rich miss out on

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the education and skills that would maximize their own economic prospects and their countries' own growth.

Latin America is an unfortunate example – where historic high concentration of land and the concentration of income associated with exploiting mineral wealth have left a legacy of limited educational opportunities, a small and state-dependent middle class and a large majority of poor and near-poor households. East Asia, in comparison, had the good luck to inherit after World War II an equal distribution of land and the political impulse (for lack of natural resources, perhaps, and for fear of Communist movements in neighboring countries) to invest heavily in education and health – producing a growing middle class based on increasing productivity in smallholder agriculture and technology-savvy job-intensive manufacturing.

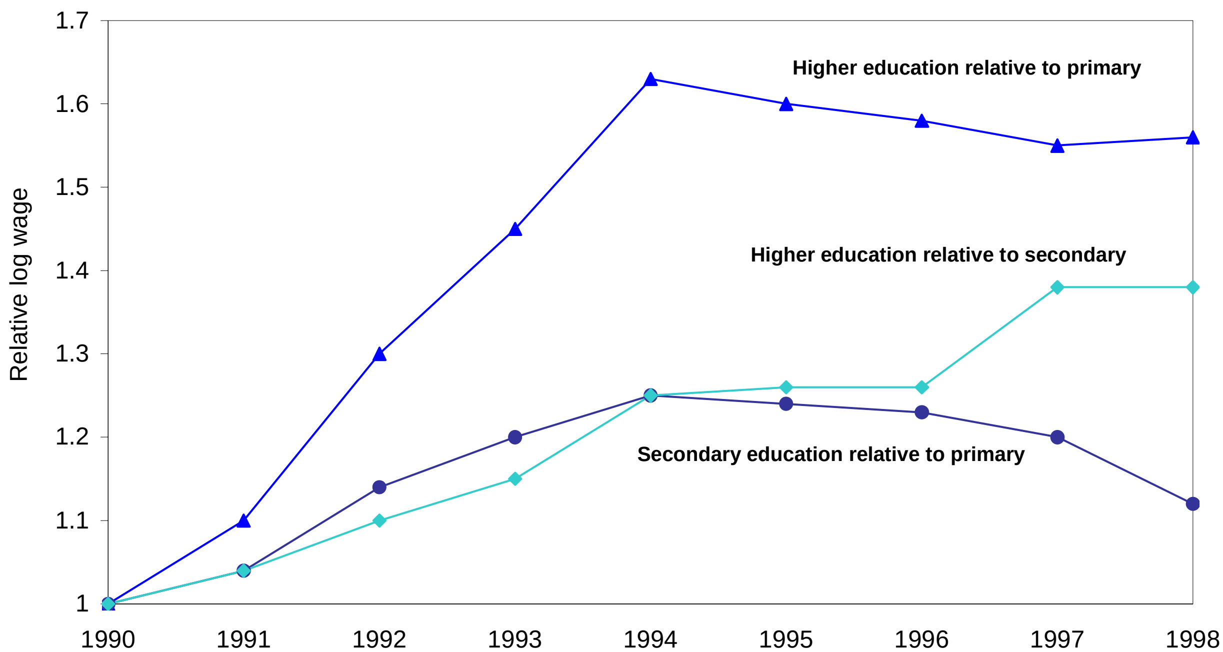
In settings where inequality has taken hold (much of sub-Saharan Africa, Eastern Europe and China in the last decade), there is also the risk that the institutions of government will, in a vicious circle, fail to respond to citizens' basic needs. It is the middle class in Western democracies that demands and commands accountable government. Most developing countries have very few households that could be called middle class – and the more unequal their income distributions the smaller their middle class. (In Brazil the 20 percent of households in the middle of the income distribution have incomes less than 10 percent of all income, and at about $1700 per capita per year are well short of "middle class." In Sweden their comfortably well-off counterparts are about 15 times richer and capture 18 percent of all income.) Without a solid middle class, even the most responsible government leaders are caught between the temptations of populism and protectionism on the one hand – using inflationary financing to quell the insecurities and frustrations of the insecure majority – and the reluctance of the rich to finance the tax burden associated with long-term productive investments in education and infrastructure. One result: In countries where inequality is high – Brazil and Nigeria – recent progress in increasing educational opportunities still leaves the children of the poor with just three to five years of education, while their rich counterparts have 10 and more years. Income and wealth inequality in one generation can too easily undermine the best governments' political capacity to guarantee more equal opportunity in the next.

## Globalization and inequality

A fundamental challenge posed by the increasing reach of global markets ("globalization") is that global markets are inherently dis-equalizing, making rising inequality in developing countries more rather than less likely. There are at least three reasons.

First, the tremendous economic gains associated with deeper and more efficient global markets are not equally shared. Markets, after all, reward those who have the right assets – financial capital, human capital, entrepreneurial skills. In fact in the global economy, it turns out that the "right" asset for individuals is higher education. The returns to higher education have been rising all over the world, especially since the early 1990s – increasing rapidly the salary premium enjoyed by university graduates.

Figure 1
Relative returns to different levels of education in Latin America




Source: Behrman, Birdsall and Szekely (2003). "Economic Policy and Wage Differentials in Latin America."

Figure 1 shows the average relative rate of return to education for 18 Latin American countries – with returns to higher education growing much faster than the returns to lower levels of education. 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 enrollments). That increases inequality within countries – China and India are good examples. It can also increase inequality across countries by encouraging emigration of highly skilled citizens, who naturally are most likely to leave the poorest countries where they are least able to deploy their skills productively.

As with individuals, some countries too entered the era of globalization with the wrong asset. Countries such as Mali, Uganda and Venezuela are highly dependent on primary commodity exports – whether oil, coffee, or cotton. They have not resisted globalization – indeed their trade ratios (exports plus imports over their GDP) were higher two decades ago than those of the today's most successful "globalizer", China, and remain comparable or higher than those of China and India today. They have also reduced their tariffs against imports to rates comparable to their developing country counterparts. But the world price of their exports has declined dramatically relative to manufacturing prices, and they have lost out, failing to grow. Without the political and economic institutions (nor the middle class) necessary to generate stable and credible policy, they have been unable to attract private investment that would have enabled them to diversify. As education is the "right" asset for individuals in the global economy, sound and stable institutions can be said to be the right asset for countries.

A second reason why globalization is dis-equalizing 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, high greenhouse gas emissions of the U.S. are imposing costs on poor countries. Similarly with global financial crises; the financial crises of the 1990s that affected Mexico, Thailand, Korea, Russian, 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. The result tends to be dis-equalizing over the long run within countries. In Korea, Mexico and Thailand, financial crises reduced the income shares of the bottom 80 percent of households compared to the top 20 percent. In Mexico, the accompanying recession in 1995 led the poor to take their children out of school – and many never returned. In developing countries, the bank bailouts that follow crises generate high public debt (amounting to 10 to 40 percent of annual GDP compared to 2-3 percent on average in advanced economies). 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 investments in health and education – and their ability to spend more on the unemployment and other safety net programs that protect the poor in bad times.

Finally, global markets tend to be dis-equalizing because trade, migration, and intellectual property 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 U.S. and Japan, as perverse as they are, matter more at the negotiating table than unequal market opportunities for cotton farmers in West Africa. What is true of the design of multilateral rules is also true of implementation. The hard-won fight of developing countries for the right to issue compulsory licenses to produce locally cheap medicines is even today not readily invoked in countries where the U.S. can issue issue backdoor threats to limit their access to the larger U.S. market.

A Global Polity

What can be done about the resulting challenge to global security, stability, shared prosperity, and most fundamentally to global social justice? Because global markets work better for the already rich (be it with education or for countries with stable and sound institutions), we need something closer to a global social contract to address unequal endowments – to increase educational opportunities for the poor and vulnerable, and to help countries build sound institutions. That is what the Millennium Development Goals are of course about. 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). And because global rules tend to reflect the interests of the rich, we need to strengthen the disciplines that multilateralism brings, and be more creative about increasing the representation of poor countries and poor people in global fora – the IMF, the World Bank, the UN Security Council, the Basle Committee for Banking Regulation and Supervision, the G-8, and so on. We need renewed efforts to complete the Doha multilateral trade round as indeed a "development" round and a willingness to contemplate new global institutions to manage new global challenges – for example an International Migration Organization.

We need, in short, creative thinking about the reality that we have a vibrant and 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 $21^{st}$ century will be to strengthen and reform the institutions, rules and customs by which nations and peoples manage the fundamentally political challenge of complementing the benefits of the global market with collective management of the problems, including persistent and unjust inequality that global markets alone will not resolve.