

# Policy Brief

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## Overview

While the economic opportunities offered by globalization can be large, a question is often raised as to whether the actual distribution of gains is fair, in particular, whether the poor benefit less than proportionately from globalization and could under some circumstances be hurt by it. This Policy Brief summarizes and examines the various channels and transmission mechanisms, such as greater openness to trade and foreign investment, economic growth, effects on income distribution, technology transfer and labour migration, through which the process of globalization affects different dimensions of poverty in the developing world.

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## *Linking Globalization to Poverty*

**G**LOBALIZATION PROVIDES A STRONG POTENTIAL FOR A MAJOR REDUCTION IN POVERTY in the developing world because it creates an environment conducive to faster economic growth and transmission of knowledge. However, structural factors and policies within the world economy and national economies have impeded the full transmission of the benefits of the various channels of globalization for poverty reduction.

World income distribution continues to be very unequal and many poor countries particularly in Africa are stagnating. Moreover, there is much empirical evidence that openness contributes to more within-country inequality. China is a good example with coastal provinces as opposed to inland provinces reaping the major benefits of globalization.

Progress on poverty reduction has also been uneven. Although the share of the population of developing countries living below US\$1 per day declined from 40 per cent to 21 per cent between 1981 and 2001, this was mainly achieved by the substantial reduction of the poor in Asia, in particular in China. Notwithstanding the drop in relative poverty, the total number of people living under US\$2 per day actually increased worldwide. In particular, poverty has increased significantly in Africa in both absolute and relative terms.

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

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

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### Channels Linking Globalization to Poverty

What are the transmission mechanisms through which the process of globalization affects poverty directly and indirectly? The first and most important of these mechanisms is the growth–inequality–poverty channel. Other channels operate, respectively, through changes in relative prices of factors of production (labour and capital) and commodities, movements of capital and labour migration across borders, the nature of technological change and technological diffusion, the impact of globalization on volatility and vulnerability, the worldwide flow of information, global disinflation, and institutions.

- ✦ Switching from import substitution to opening up the domestic economy to imports leads over time to more efficient resource allocation and a higher growth path.
- ✦ Foreign direct investment raises the productive capacity of the receiving countries, and is often the conveyor belt for transferring technology and know-how.

The second link in the causal chain from openness to poverty is the interrelationship between growth and inequality. While it is most likely that the poor will benefit from growth, the ultimate poverty-reduction effects will depend on how the growth pattern affects income distribution. If growth leads to an increase in income inequality, the poor may benefit only slightly or,

Globalization affects poverty through many different channels: growth, inequality, international capital movements and labour migration, technology, information, vulnerability, and institutions...

### The Globalization–Growth–Inequality–Poverty Causal Chain

To analyze and understand the impact of openness on poverty, the globalization–openness–growth–inequality–poverty causal chain has to be scrutinized link by link. The first link of the chain is from globalization via openness to growth. The main manifestation of openness is through trade and capital movement liberalization, which in turn is presumed to affect growth directly through increased exports, imports, and capital inflows:

- ✦ Trade liberalization policies encourage exports, which benefit export industries and contribute directly to GDP growth.

in some instances, actually be hurt by the globalization process. Indeed, the growth–inequality link is much more complicated than what the classical approach postulated with its emphasis on the growth-enhancing effects of inequality (the rich save a larger proportion of their incomes than the poor so that the impoverishment of the masses is a precondition to higher investment and growth). Inequality is responsible for many consequences of and phenomena that, at least potentially, could reduce future growth and hence future poverty alleviation, notably the diffusion of social and political instability and conflict that could dampen investment because of greater uncertainty.

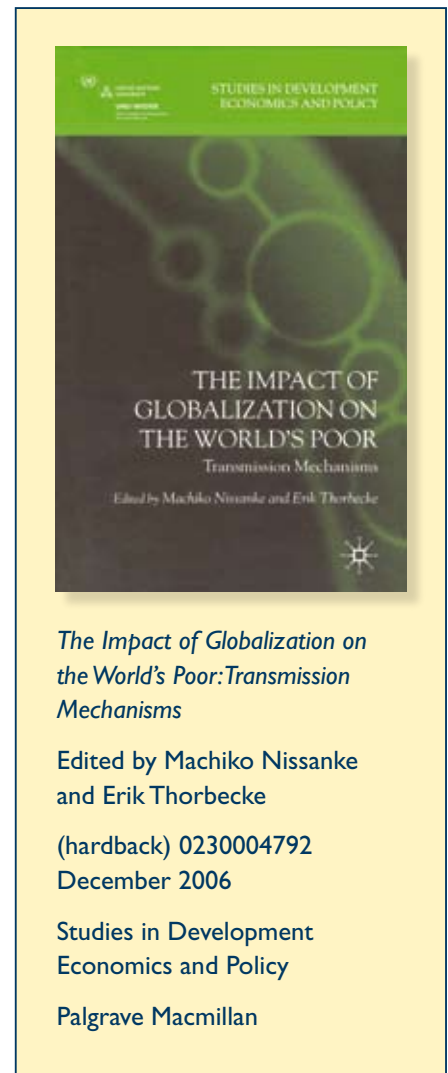
The final link in the globalization–poverty nexus captures the combined net effect of growth and a change in income inequality on poverty. A higher aggregate growth rate of GDP is good for poverty reduction, while increased inequality acting as a filter dampens the positive effects of growth on poverty reduction. Consequently, policymakers should focus on the pattern (structure) of growth and development rather than the rate of growth *per se*. In short, poverty reduction requires a combination of higher growth and a more pro-poor distribution of the gains from growth.

### Empirical Evidence

*The Impact of Globalization on the World's Poor* provides empirical evidence regarding the crucial importance of the pattern of growth on the extent of poverty reduction. In terms of economic sectors, evidence shows that in early development stages the growth of agriculture has a far greater impact on poverty than the growth of other sectors. For example, the bulk of the poverty reduction in China occurred during the phase of agricultural

gain or lose from openness depends on whether they are net buyers of tradable goods (such as rice). It also depends on the extent to which the retail market structure is monopolistic, blocking the pass-through from border prices to domestic prices.

- As recipients of public services, globalization can affect the poor in two ways, first, through budget cuts mandated by international agencies to reduce budget deficits and achieve macroeconomic stabilization, and second, through falls in tariff revenues following trade liberalization. Governments often find it politically more expedient to cut public expenditures for the voiceless poor. At the same time it is easy to blame the globalization process for domestic institutional failures that could at least partially be remedied through an attack on corruption and insisting on greater accountability by domestic institutions.
- As users of common property resources, the rural poor can potentially be hurt if trade liberalization encourages overexploitation (such as massive deforestation) of fragile environmental resources. The dilemma is that it may



## Poverty reduction requires a combination of higher growth and a more pro-poor distribution of the gains from growth

de-collectivization and increases in food prices procurement before 1980, rather than in the subsequent trade-opening phase. Regional characteristics also play a dominant role on how inequality and poverty are affected by different globalization components. And inequality in the initial income distribution affects poverty indirectly and diminishes prospects for pro-poor growth.

The great majority of the poor live in rural areas.

- As consumers, whether the rural poor

be difficult and even counter-productive for a country to adopt environmental regulations while its competitors do not adopt them at the same time and thereby are able to undercut the former in world markets. The policy recommendation that suggests itself is greater coordination of environmental regulations on an international scale.

In addition, many small farmers are heavily dependent on multinational marketing chains for establishing a foothold in global markets, as these products require new storage and

transport infrastructure, large set-up costs, and marketing connections. Such circumstances require protecting the poor through new legal rules and institutional structures that facilitate contract farming and agro-processing without exposing small producers to exploitation by large marketing chains. More energetic international attempts might be called for to certify codes against international restrictive business practices and to establish an international anti-trust investigation agency, possibly under WTO auspices.

The investigation of global value chains—horticulture, garments, and textiles—in Bangladesh, Kenya, South Africa, and Vietnam provides evidence on the impact of globalization on employment and economic opportunities for poor people. This analysis makes a clear conceptual distinction between ‘non-globalizer’ and ‘unsuccessful globalizer’ countries.

Kenya is categorized as an unsuccessful globalizer, while Vietnam is considered to have been successful in integrating into the world economy in terms of outcome though remaining relatively closed in terms of policy. Further, the impact of increased exports on employment has been much more significant in Bangladesh and Vietnam, where unskilled labour intensive industries accounted for 90 per cent and 60 per cent of manufactured exports in the late 1990s, respectively, than in Kenya and South Africa, where the corresponding figures were 16 per cent and 10 per cent respectively. In these two African countries, skilled workers (as proxied by education levels) benefited from globalization while unskilled workers were adversely affected.

The value chains of horticulture exports in Kenya and garment exports in Bangladesh and Vietnam show that the growth of labour intensive exports

does create employment opportunities, particularly for low income women and migrants from rural areas. However, the requirements of global value chains mean that these jobs often demand a high degree of labour flexibility, long hours of work, and poor working conditions, making workers vulnerable both in terms of employment security and income. Opening up to global competition has also led to job losses and deterioration in working and employment conditions, as the case of textile industries in South Africa illustrates. Another relevant finding is that the gains from globalization are likely to be more widely distributed where the initial structure of assets and entitlements is more equitable. In any case since only a minority of the poor are engaged in global production, integration with the global economy can help but is not a substitute for an anti-poverty strategy.

### **The Globalization–Capital and Labour Mobility–Poverty Channel**

According to economic theory, the impact of globalization on developing countries well endowed with unskilled labour should lead to a decline in income inequality through an increased demand for unskilled labour, while unskilled labour in developed countries would lose out with an adverse effect on equity. However, the empirical evidence reveals that wage gaps between skilled and unskilled labour have been increasing in many developing countries, particularly in Latin America and Africa.

Several specific features associated with the current phase of globalization explain why the theoretical prediction does not hold. For example, the nature of technical progress and new technology is heavily biased in favour of skilled and educated labour, as technical change emanates from R&D activities



in the developed (industrialized) countries in response to local conditions. Hence, technical change tends to be labour-saving and skill-biased, and new technology is complementary to capital and skilled labour, while it is a substitute for unskilled labour and tends to increase inequalities in both developed and developing countries. Furthermore, technological diffusion and access to new technology is not universal and spontaneous, while intensified privatization of research (e.g. in biotechnology) may have adverse effects on access to new technology by developing countries and the poor. The resulting widened productivity differences explain cross-country wage/income inequality.

‘Perverse’ factor movements could provide another explanation. Capital and skilled labour do not migrate to poor countries as much as among developed countries. Rather, there is a tendency for skilled labour to migrate from developing countries to developed countries, as the massive migration of African nurses and Philippine and other Asian medical doctors to the US and Europe testifies, while unskilled labour migration tends to be strictly controlled. With capital market liberalization, there is a propensity for capital flight from developing to developed countries, particularly during periods of instability and crisis.

Income convergence among the globalizing countries during the first wave of modern globalization was driven primarily by migration. Sixty million people, including largely unskilled workers, migrated from Europe to North America and other parts of the new world between 1870 and 1914. In contrast, the extent of cross-border mobility differs significantly between skilled and unskilled labour in the current phase of globalization. Unskilled workers from developing countries face increasing obstacles in their attempts

to migrate to developed countries. In consequence, wage equalization does not take place through labour migration, as was the case in the previous globalization era. Some workers lose out as de facto labour mobility takes place through the increasingly free cross-border capital mobility as well as to transnational corporations’ ability to re-locate production sites in response to changes in relative labour costs. In fear of driving away these corporations, governments of developing countries are less likely to enact regulations to protect and enhance labour rights.

### The Globalization–Technology–Poverty Channel

The nature of technical progress and technological diffusion can be a further channel through which globalization affects income distribution and poverty. As indicated, technological change tends to be highly capital and skill-intensive and unskilled labour-saving, as befits the resource endowment of the rich industrialized countries where most innovations originate.

Even though much of the new technology does not conform to the resource endowment of poor countries, the potential exists for globalization to confer significantly higher food productivity and rural incomes on developing countries via the mechanism of North–South technology transfer. For example, to realize the potential positive effects of biotechnology on poverty reduction, the public and private sectors must:

- + establish institutions with local capacity for technology innovation and adaptation,
- + reduce transaction costs in the process of international transfer of technology, and
- + provide standardization, transparency, and access to information for property rights over technologies.

In addition to significant investment



in higher education and research capacity in low-income countries, a new type of institution (namely the Intellectual Property Rights Clearinghouse) might be capable of overcoming the lack of access to intellectual property rights and the burden of high royalty payments for small and poor farmers in the developing world.

Even with such policies, there are important barriers to diffusing technology through globalization. Even if a new technology can potentially increase the income level of small farmers, its diffusion may be slow due to sunk costs of adoption and uncertainties about net payoffs of the technology in question. The lack of capital, credit, and risk-sharing possibilities as well as limited access to information about new technologies hinders technology

observed in Central and East Europe since the early 1990s is strongly related to trade shocks encouraged by trade liberalization. Consequently trade liberalization, as implemented in the 1990s, may have actually worsened growth and welfare performance in Eastern Europe. Furthermore, the analysis indicates that the per capita income of the poorest population quintile is most vulnerable to these trade shocks. These results point to the need for emerging and transition economies to adopt forward-looking national policies to support trade liberalization, that is, policies to mitigate the impact of trade shocks, and enhance coping mechanisms. A new 'culture of prevention' with mechanisms for limiting the size and frequency of shocks at the international level might also be called for.

## The provision and distribution of public services play a major role in determining public perceptions about the benefits and fairness of globalization

adoption and diffusion. Adoption of new technologies can be slowed by uncertainties about their efficiency. For example, without independent external information sources, farmers in developing countries have to rely heavily on their neighbours ('leaders' who have already adopted the technologies) to obtain vital information about new methods.

### **Other Channels: Vulnerability, Information Diffusion, and Institutions**

Beyond increasing aggregate income, globalization increases uncertainty via greater variation in income and expenditure caused by global shocks, such as the various financial crises that have hit Latin America and Asia in the last two decades. It was found that the extremely high volatility of consumption

The 'economics of happiness' is a way to address the noticeable differences observed between standard measures of poverty and inequality and people's subjective assessments. That is, it can help explain discrepancies between economists' assessments of the benefits of globalization for the poor and individuals' real and perceived welfare outcomes—such as vulnerability to falling into poverty among the near poor; distributional shifts at the local, cohort, and sector level—and changes in the provision and distribution of public services. The latter factors play a major role in determining public perceptions about the benefits and fairness of the globalization process.

It can be argued that while globalization is a major engine for growth in aggregate, it introduces or exacerbates other trends that affect

people's well-being as much as if not more than income, for example, through the increasing flow of information about the living standards of others, both within and beyond country borders. This flow of information can result in changing reference norms and increased frustration with relative income differences, even among respondents whose own income is rising. For example, individuals in a

poverty. Institutions act as a filter intensifying or hindering the positive and negative pass-through between globalization and poverty and can help explain the diversity, heterogeneity, and non-linearity of outcomes. For example, on the one hand, the impact of globalization on the poor is mediated by domestic political economy structures and institutions such as social polarization, oligarchic structures, and

capabilities through learning and adaptation. To succeed, developing-country governments should consciously engage in building institutional capacities for integration, including a capable nation-state that is ready to take on the enormous challenges posed by globalization. These institutional structures should be specific to and consistent with each country's initial conditions.

## Safety nets and social protection schemes that shelter the assets of the poor during crises should be given high priority

given developing country compare their incomes increasingly with those of relatively similar individuals in developed countries rather than within their own country. Increased insecurity, and the very real threat of falling into poverty for the near poor and lower middle classes, contributes to negative perceptions of the globalization process, particularly in countries where social insurance systems are weak or where existing systems are eroding.

Many social and collective measures should be in place for globalization to have positive effects on poverty. These include measures such as:

- ♦ public investments in health,
- ♦ institutions that can ensure adherence to basic norms of equity and fairness, and
- ♦ collective investments in social insurance to protect workers from the volatility that often accompany integration into global markets.

In the absence of these measures, the process of globalization may only create opportunities for those that are best positioned to take advantage of them, leaving behind large sectors of poor and vulnerable individuals.

Institutions mediate the various channels and mechanisms through which the globalization process affects

predatory regimes, which may bias, confiscate or nullify the gains from globalization for particular groups of poor. On the other hand, the positive effects of globalization on growth and poverty can be found when institutional conditions are characterized by such features as political participation, social cohesion and management of social conflict arising directly from globalization effects. Consequently, safety nets and appropriate social protection schemes that shelter the assets of poor households (and particularly the erosion of their human capital) during crises triggered by globalization should be given high priority.

### **Proactive Development Policies to Benefit from Globalization**

The outcomes of globalization processes are highly context-specific, dependent both on the institutional framework and government policies that mediate global processes. To benefit from globalization's dynamic forces, developing countries need to take strategic steps with a long-term vision for upgrading their comparative advantages towards high-value added activities by climbing the technology ladder. This can be realized by developing technological

In short, policymakers need to design and implement an active development strategy not only to benefit from, but also to help counteract the negative effects of the immutable forces of globalization. Globalization should not be viewed as a reliable substitute for a domestic development strategy. Governments cannot passively wait for the fruits of the Washington Consensus and the market forces of globalization to pull them on a fast track to development. Instead, governments of developing countries need to pursue both a process of strategic integration and active domestic pro-poor development policies.



The World Institute for Development Economics Research (WIDER) was established by the United Nations University (UNU) as its first research and training centre and started work in Helsinki, Finland in 1985. The Institute undertakes applied research and policy analysis on structural changes affecting the developing and transitional economies, provides a forum for the advocacy of policies leading to robust, equitable, and environmentally sustainable growth, and promotes capacity strengthening and training in the field of economic and social policy making. Work is carried out by staff researchers and visiting scholars in Helsinki and through networks of collaborating scholars and institutions around the world.

**INSIDE:**  
**Policy Brief**  
*“Linking  
Globalization to  
Poverty”*

While globalization offers new opportunities for accelerating development and poverty reduction it also poses new challenges for policymakers; in particular whether the poor gain from globalization, and under what circumstances it may actually hurt them.

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