

# The Effects of Globalization on World Income Inequality

**Ercan Ekmekçioğlu**

Kyrgyz Turkish Manas University-Department of Economy  
720044, Bishkek, Kyrgyzstan

## **Abstract**

*Globalization is defined as the transfer or easy flow of goods, services and capital from one country to another. Due to this rapid transfer in trade across boundaries, this article attempts to bring out the relationship that exists between globalization and income inequality levels across regions, and among individuals within different countries. To do this the article brings clearly the empirical evidence that various economic researchers have come up with, and most important is that there are various schools of thought giving different view points in so far as this relationship is concerned. Therefore this article seeks to give a comprehensive look in the various view points, and through empirical evidence comes up with a rational and factual analysis on the effects that globalization has on income inequality.*

**Keywords:** Globalization, Income inequalities, growth.

**JEL Classification Numbers:** D63, F15.

## **I. Introduction**

Globalization according to (Alms Heshmati 2003, pg 2) is generally defined as the free transfer or movement of goods, services and capital across borders of different countries. He goes ahead to say that it is a continuous process by which the western market economies have effectively spread across the globe. In line with this definition, the whole process of integrating the economy of the world has reached unprecedented levels surpassing the pre-World War I peak. Consequently, this new change in the world economic environment has brought far reaching consequences in the economic well-being of individuals in all regions of the world and more importantly among all income groups.

Globalization according to some authors has been accompanied by an increasing rate in inequality in terms of income distribution, and this has happened both in the developed and the developing nations. The data on growth and income inequality seem to contradict the optimism of the proponents of globalization. The empirical evidence suggests in fact that, for most countries, the last two decades have brought about slow growth and rising inequality. Therefore, from Cornia's Perspective, globalization is responsible for the ever increasing disparity in income levels between individuals in various regions. In support of this, it has been found that globalization has a positive correlation between inequality in incomes and the production outsourcing processes (Cornia 1999, pp1). As a result of outsourcing of production being carried out by the multination corporations, it is therefore inevitable that it will lead to inequality between highly skilled workers and the least qualified as the former attracts huge wages compared to what the latter earns as salary (Fenster and Hanson 1999 Pg 371-393).

## **II. International Trade Theory**

In light of the international trade theory as postulated by the neo-classical (Heckscher-Ohlin model and one of its theorems, the Stolper-Samuelson theorem, 1941), being open in the process of doing business leads to an increase both in the real and nominal return on the abundant factor in a country and conversely to a scarce factor. Therefore for countries endowed with abundant supply of both physical and human capital, for instance the developed nations, trade openness or liberation has significantly improved the real and nominal income for the proprietors of the named two factors of production. In essence, what this economic relationship means is that this arrangement reduces inequality levels within the developing countries, and quite the opposite for developed countries of the world.

In summary, globalization has eventually resulted to a reduction in inequality in less developed countries and an increase in inequality in the advanced developed countries. (Wood, 1994 Pg 25-41; Bourguignon and Morrison, 1990 Pg 1113-1132; Calderon and Chong, 2001 Pg 225-231; Dollar and Kraay, 2004 Pg 22-49; Hanson and Harrison, 1999 Pg 271-288; Arellano and Bond, 1991 Pg 277-297; Arellano and Bover, 1995 Pg 29-51; Barro, 2000 Pg 5-32). But most important is that, this conclusion contradicts the commonly-accepted "popular view" on globalization and its impacts, this contradiction is well captured by Barro (2000:p27) when he confirms that: "the standard theory seems to conflict with the concerns expressed in the ongoing popular debate about globalization. The general notion is that an expansion of international openness will benefit most the domestic residents who are already relatively well off".

Bergh and Nilsson (2010) used the KOF index of globalization and the Fraser index of economic liberalization and in summary concluded that reforms in support of economic liberalization tend to increase inequality in developed nations, confirming the results of the Stolper-Samuelson theorem. As for middle- and low-income countries, the study found out that the major driver of the increase of income inequality is social globalization, one of the KOF index components including the number of telephone calls and the number of users of internet, among other indicators.

## **III. Foreign Investments**

Due to globalization there has been a significant correlation between foreign direct investments (FDI) and income inequality levels in the world. Globalization has resulted to increase in the flow of foreign direct investments between countries and this flow has brought a fundamental impact in the distributive consequences among various economies. Studies by economists such as Mundell 1957 (Pg 321-335) found out that foreign direct investments (FDI) into developing nations has had a remarkable effect of reducing inequality levels in terms of income distributions. His major reason being that, foreign direct investment flows mainly from the developed nations to developing world leading to a general rise in the capital quantity in the developing countries, which subsequently means that the marginal physical product of labour increases. As a result of this increase in the marginal physical product, real wages as well as nominal wages are bound to increase hence reducing inequality in the developing nations.

In contrast to the view envisaged by the neoclassical economic theory, is the dependency theory. This body argued that dependency by the developing nations on the advanced developing nations has brought negative economic and social implications for the former, and more so in the long term. According to this school of thought, this dependency is manufactured

and maintained mainly by the existing trade dependency and dependency on foreign direct investment movements. Major proponents of this school of thought argue that the penetration of FDI in middle and low income countries hampers economic growth and increases income inequality by creating dualism and disparities in various economies and their productive structures. For instance, the multinational companies create a highly capital intensive export sector, are distant apart and function differently or uniquely from the rest of the economy, utilizing most of the resources present in an economy, and the existing capital and credit, and more so repatriating most of the profits and wealth earned in these economies. This same divisive effect is also found to exist up to the local level where through the penetration of foreign direct investments, multinationals have produced and maintained local elites whose function is majorly to ensure that the interests of multinational companies, which invariably are the perpetuation of cheap labour, ergo poor and marginalized workers (Firebaugh and Beck, 1994 Pg 631-653; Stringer, 2006).

The pessimistic position in as far as the roles of multinational firms (MNF) and foreign direct investment is concerned is, contradicted by the report of the World Investment (WIR). World Investment Report of 2009 (WIR), states that the five most attractive countries for multinationals are the BRIC countries (Brazil, Russia, India and China) and the United States. Despite the fact that they are not being considered developed countries, the BRICs are unique because they are emerging, rapid-growth economies, that is, they are countries whose per-capita income or gross domestic product is higher than less developed nations and on the other side lower than those of advanced developed nations. In the first fifteen major FDI destinations, Vietnam currently lies in position six, followed closely by Germany and Indonesia. Other nations that lie within the fifteen group members are Poland, South Africa, Turkey, France, the United Kingdom and Canada. Regarding the factors that explain reasons for FDI attractiveness, the report did put a lot of emphasis on the growth and size of the international market, gaining of access to regional and international markets, availability of skilled labour, provision of quality infrastructure, the economic and business environment as well as legal environment.

According to Feenstra and Hanson (1997, Pg 371-393), the flow of foreign direct investments into the developing countries has been found to create or widen inequality levels in those countries. The reason being that transfer of capital from the wealthy nations to the poor nations (developing), is equivalent to outsourcing of activities which according to the developed nations views, are low skilled labour intensive and vice versa for the developing countries. This massive transfer of capital to the developing nations has created a huge demand for skilled labour which proportionately has pushed up the relative wages earned by this skilled workforce. But on the other hand, the relative wages earned by the unskilled workforce has deteriorated in the developing country which therefore means that inequality has increased. Important is that this fact was proved in the study carried out in Mexico over the period 1975-1988.

Another study also affirms that increased penetration of foreign direct investment which is a product of globalization has continued to widen the gap of inequality among the developing nations. The issue being that besides multinational companies outsourcing activities that rely heavily on low qualified cheap labour, they also introduce new technologies that previously never existed in the developing nations. Therefore, initially the introduction of these new technologies will create a demand for highly skilled workers to operate these machines leading

to an increase in their wage levels, and consequently this creates inequality as well as market segmentation. This study was finally proved in Ireland in the period 1979-1995 in which the evidence found supported the so called inverted-U shape relationship between wage inequality and inward flows of foreign direct investment. This fact is supported by studies from who found out that diffusion or transfer of technology from the developed nations to the less developing only continues to widen inequality levels in income distributions in the middle income developing countries, due to the fact that these countries are known for higher absorption capacity for new technologies compared to their low income developing counterparts (Firebaugh and Beck 1994:631-653, Stringer 2006, Windmeijer 2005:25-51, Mahler, Jesuit and Roscoe 1999: 363-395, Figini and Gorg (1999:135-145).

Meschi and Vivarelli (2007:19) summarize that: “the multinational companies have the necessary capabilities in order to use the technologies produced in more advanced countries and to follow a catching-up pattern of development. While this process may have a positive impact on economic growth, it is very likely that it also implies an (at least temporary) increase in the demand and wages for skilled labour. In contrast, trade with LICs is often confined to the importation of older (or second-hand) capital equipment that requires fewer skills to operate than technologically updated equipment. Therefore – as far as LICs are concerned – trade with more advanced countries may not have the same adverse consequences in terms of income distribution.”

#### **IV. Summary**

In conclusion, globalization has continued to be a force in the current business environment, and as such continues to impact the lives of individuals in every nation of the world. This is due to the fact that multinational corporations continue to be the major avenues of doing business in the world, owing to their huge pull of capital, and in the process make globalization inevitable in the world to day. But most important is that, globalization has not solved the problem of income inequality entirely as it has instead increased income inequality in the developed nations while reducing the income gap with the developing countries.

#### **References**

- Almas H. 2003. The Relationship between Income Inequality and Globalization. Helsinki, Finland. <http://www.wider.unu.edu/> Viewed on 3<sup>rd</sup> October 2011,
- Arellano, M., Bond, S., 1991. Some tests of specification for panel data: Monte Carlo evidence and an application to employment equations. *Review of Economic Studies* 58,2, 277-297,
- Arellano, M., Bover, O., 1995. Another look at the instrumental variable estimation of error components models. *Journal of Econometrics* 68, 1, 29-51,
- Bourguignon, F., Morrisson, C., 1990. Income distribution, development and foreign trade. *European Economic Review* 34, 1113-1132,
- Barro, R., 2000. Inequality in a Panel of Countries. *Journal of Economic Growth* 5, 5-32,
- Calderon, C., Chong, A., 2001. External sector and income inequality in interdependent economies using a dynamic panel data approach. *Economics Letters* 71, 2, 225-231,

- Cornia, G., 1999. Liberalisation, Globalization and Income Distribution, UNU/WIDER Study, Dollar, D., Kraay, A., 2004. Trade, Growth and Poverty. *The Economic Journal* 114,493,22-49, Feenstra, R., Hanson, G., 1997. Foreign direct investment and relative wages: Evidence from Mexico's maquiladoras. *Journal of International Economics* 42, 371-393, Firebaugh, G., Beck, F., 1994. Does economic growth benefit the masses? Growth, dependence, and welfare in the Third World. *American Sociological Review* 59, 5, 631-653, Figini, P., Gorg, H., 1999. Multinational companies and wage inequality in the host country: the case of Ireland. *Weltwirtschaftliches Archive/Review of World Economics* 135, 4, 135-145, Hanson, G., Harrinson, A., 1999. Trade and wage inequality in Mexico. *Industrial and Labour Relations Review*, 52, 2, 271-288, Mahler, A., Jesuit, K., Roscoe, D., 1999. Exploring the impact of trade and investment on income inequality. *Comparative Political Studies* 32, 3, 363-395, Meschi, E., Vivarelli, M., 2007. Globalisation and Income Inequality. IZA Discussion Paper 2958, Mundell, R., 1957. International Trade and factor Mobility. *The American Economic Review* 47, 3, 321-335, Stringer, J., Unpublished results. Foreign Direct Investment and Income Inequality in Developing Countries: An Exploration of the Causal Relationship Using Industry Level FDI Data. Document prepared for the 2006 annual Midwest Political Science Association conference. Windmeijer, F., 2005. A finite sample correction for the variance of linear efficient two-step GMM estimators. *Journal of Econometrics* 126, 25-51. Wood, A., 1994. *North-South Trade, Employment, and Inequality: Changing Fortunes in a Skill-Driven World*. Clarendon Press, Oxford.