GLOBALIZATION, GROWTH, AND POVERTY

A World Bank Policy Research Report

GLOBALIZATION, GROWTH, AND POVERTY:

BUILDING AN INCLUSIVE WORLD ECONOMY

A copublication of the World Bank and
Oxford University Press

1818 H Street, NW
Washington, DC 20433

1 2 3 4 04 03 02 01

A copublication of the World Bank and Oxford University Press.

Oxford University Press
198 Madison Avenue
New York, NY 10016

Oxford University Press ISBN 0-19-521608-3
World Bank ISBN 0-8213-5048-X

Library of Congress Cataloging-in-Publication Data has been applied for.

Contents

Boxes

Figures

Maps

Tables

Foreword

GLOBALIZATION—THE GROWING INTEGRATION OF economies and societies around the world—is a complex process that affects many aspects of our lives. The terrorist attacks on the United States on September 11 were one aspect of globalization. Rapid growth and poverty reduction in China, India, and other countries that were poor 20 years ago is another. The development of the internet and easier communication and transportation around the world is a third. The spread of AIDS is part of globalization, as is the accelerated development of life-extending technologies. Something so complex cannot be analyzed in a single book, and our objective is more humble than examining all aspects of globalization. The focus of our research is the impact of economic integration on developing countries and especially on the poor people living in these countries. About one-fifth of the world's population lives on less than $1 per day, and that is unacceptable in a world of such plenty. Whether economic integration supports poverty reduction and how it can do so more effectively—these are the key questions that we ask.

Our research yields three main findings that bear on current policy debates about globalization. First, poor countries with around 3 billion people have broken into the global market for manufactures and services. Whereas 20 years ago most exports from developing countries were of primary commodities, now manufactures and services predominate. This successful *integration* has generally supported poverty reduction. Examples can be found among Chinese provinces, Indian states, and the countries of Bangladesh and Vietnam. The 'new globalizers' have experienced large-scale poverty reduction: during the 1990s the number of their people who were poor declined by 120 million. Integration would not have been feasible without a wide range of domestic reforms covering governance, the investment climate, and social service provision. But it also required international action, which provided access to foreign markets, technology, and aid.

The second finding concerns *inclusion* both across countries and within them. One of the most disturbing global trends of the past two decades is that countries with around 2 billion people are in danger of becoming marginal to the world economy. Incomes in these countries have been falling, poverty has been rising, and they participate less in trade today than they did 20 years ago. In the extreme, some of these are failed states, such as Afghanistan or the Democratic Republic of the Congo. The world has a large stake in helping countries integrate with the global economy, and we highlight a range of measures that would make this easier and lead to greater inclusion of countries in contemporary globalization. These measures range from better access to rich country markets to greater volumes of foreign aid, better managed.

Within countries that have succeeded in breaking into global manufacturing markets, integration has not, typically, led to greater income inequality. Nevertheless, there are both winners and losers from globalization. Both owners of firms and workers in protected sectors are likely to lose from liberalization and a more competitive economy, whereas consumers and those who find jobs in new firms will be among the winners. It is important to counter the risks of loss through social protection, and such measures are affordable in the context of the economic gains that the new globalizing countries are experiencing.

A third issue concerns *standardization* or *homogenization.* Opinion polls in diverse countries reveal an anxiety that economic integration will lead to cultural or institutional homogenization. Yet societies that are all fully integrated into the global economy differ enormously. Among the richest countries, Japan, Denmark, and the United States are each quite different in terms of culture, institutions, social policies, and inequality. Among the developing country globalizers, it is again striking that countries such as China, India, Malaysia, and Mexico have taken diverse routes toward integration and remain quite distinctive in terms of culture and institutions. Diversity may be more robust than is popularly imagined. Nevertheless, some recent developments in the global trading and investment regime are pushing countries toward an undesired standardization. It is important that global trade and investment agreements respect countries' freedoms in a range of areas from intellectual property rights, cultural goods, and environmental protection to social policies and labor standards. Globalization does not need homogenization, and it is important that diversity be respected in international agreements. There is also a real danger that the imposition of global standards could be used as the excuse for a resurgence of rich country protectionism.

In sum, global economic integration has supported poverty reduction and should not be reversed. But the world economy could be much more inclusive: the growth of global markets must not continue to bypass countries with 2 billion people. The rich countries can do much, both through aid and trade policies, to help the currently marginalized countries onto the path of integration that has already proved so effective for the new globalizers.

Nicholas Stern
Senior Vice President
and Chief Economist
The World Bank
December 2001

The Report Team

THIS REPORT WAS PREPARED UNDER THE SUPERVISION OF Nicholas Stern, Chief Economist and Senior Vice President. It was written by Paul Collier (Director, Development Research Group) and David Dollar (Research Manager in the Development Research Group). The report draws on original research by these authors and by Ximena Clark, Richard Freeman, Mary Hallward-Driemeier, Christiane Kraus, Jean Lanjouw, Peter Lindert, Will Martin, Remco Oostendorp, Martin Rama, Sergio Schmukler, Zmarak Shalizi, John Sutton, Tony Venables, Jeff Williamson, Michael Woolcock, and Pablo Zoido-Lobaton. Their individual papers are available on our globalization website: www.worldbank.org/research/global. We thank for their excellent work Polly Means, who did the graphics; Emily Khine and Audrey Kitson-Walters, who processed the report; Andrew Phillips, who edited it; and Heather Worley and Susan Graham, who were in charge of production. We also thank for helpful comments on earlier drafts Caroline Anstey, Alan Gelb, Ian Goldin, Guillermo Perry, Guy Pfeffermann, Josef Ritzen, Halsey Rogers, and Roberto Zagha.

The judgments in this Policy Research Report do not necessarily reflect the views of the World Bank Board of Directors or the governments they represent.

Overview

SOCIETIES AND ECONOMIES AROUND THE WORLD ARE becoming more integrated. Integration is the result of reduced costs of transport, lower trade barriers, faster communication of ideas, rising capital flows, and intensifying pressure for migration. Integration—or "globalization"—has generated anxieties about rising inequality, shifting power, and cultural uniformity. This report assesses its impact and examines these anxieties. Global integration is already a powerful force for poverty reduction, but it could be even more effective. Some, but not all, of the anxieties are well-founded. Both global opportunities and global risks have outpaced global policy. We propose an agenda for action, both to enhance the potential of globalization to provide opportunities for poor people and to reduce and mitigate the risks it generates.

Globalization generally reduces poverty because more integrated economies tend to grow faster and this growth is usually widely diffused. As low-income countries break into global markets for manufactures and services, poor people can move from the vulnerability of grinding rural poverty to better jobs, often in towns or cities. In addition to this structural relocation, integration raises productivity job by job. Workers with the same skills—be they farmers, factory workers, or pharmacists—are less productive and earn less in developing economies than in advanced ones. Integration reduces these gaps. Rich countries maintain significant barriers against the products of poor countries, inhibiting this poverty-reducing integration. A "development round" of trade negotiations could do much to help poor countries better integrate with the global economy and is part of our agenda for action.

Globalization also produces winners and losers, both between countries and within them. Between countries, globalization is now mostly reducing inequality. About 3 billion people live in "new globalizing" developing countries. During the 1990s this group grew at 5 percent per capita compared to 2 percent for the rich countries. The number of extreme poor (living on less than $1 per day) in the new globalizers declined by 120 million between 1993 and 1998. However, many poor countries—with about 2 billion people—have been left out of the process of globalization. Many are becoming marginal to the world economy, often with declining incomes and rising poverty. Clearly, for this massive group of people, globalization is not working. Some of these countries have been handicapped by unfavorable geography, such as being landlocked and prone to disease. Others have been handicapped by weak policies, institutions, and governance; yet others by civil war. Addressing the marginalized areas is a key part of our agenda for action. Reducing poverty in these areas will require a combination of policy reform to create a better investment climate; development assistance to address problems of education and health; and out-migration to more favorable locations, both within and across national boundaries.

Within countries, globalization has not, on average, affected inequality, although behind the average there is much variation. The rapid growth in the new globalizers can be a political opportunity for redistribution policies that favor the poor, since higher-income groups need not lose absolutely. For example, programs specifically designed to promote nonfarm employment can help people who remain in rural areas. There are also some predictable circumstances in which opening up is likely to increase inequality unless offset by other policies, such as when educational attainment is very unequal. Promoting education, particularly for poor people, is equalizing, improves health standards, and enhances the productivity growth that is the main engine of poverty reduction. The fact that globalization does not on average increase inequality within countries disguises the reality that there will be specific winners and losers in each society. Good social protection policies can be a key factor in helping people prosper in this more dynamic environment.

Finally, much of the concern about globalization involves issues of power, culture, and the environment. Globalization does involve shifts in power, but these do not always favor the already powerful. For example, China and India are rapidly becoming major economies; intensifying competition has forced corporations to reduce price mark-ups over cost; and many wages are rising rapidly in the new globalizers. Governments retain a wide range of choice, most notably in distributional policies. Due to globalization, policies to counter terrorism and civil war will need to be globally coordinated. Globalization poses cultural challenges: there is often greater diversity as foreign cultures and peoples are introduced. Sometimes foreign culture, or simply the sheer pace of economic change, threatens to displace local culture and societies can legitimately seek to protect it. Global growth also threatens the environment. Some pollution issues require local regulation. Governments may potentially compete to weaken regulations in a so-called race to the bottom. However, the evidence suggests that this is not happening: in key areas environmental standards are actually rising. Other issues, such as global warming, require a global response. That capacity has so far been lacking. But for the first time in history a global civil society has emerged—"globalization from below." This can become a powerful impetus to global collective action, both for improving the environment and for reducing poverty.

Globalization reduces poverty, but not everywhere

SINCE 1980 THERE HAS BEEN UNPRECEDENTED GLOBAL integration. In Chapter 1, we contrast this new wave of globalization with two previous waves. We analyze its processes and show how it is affecting poverty and equity.

The first wave of modern globalization took place from 1870 to 1914. Advances in transportation and negotiated reductions of barriers opened up the possibility for some countries to use their abundant land more productively. Flows of goods, capital, and labor all increased dramatically. Exports relative to world income nearly doubled to about 8 percent. Foreign capital more than tripled relative to income in the developing countries of Africa, Asia, and Latin America. Migration was even more dramatic. Sixty million people migrated from Europe, primarily its less developed parts, to North America and other parts of the New World. South-South labor flows were also substantial. The flows from densely populated China and India to less densely populated Sri Lanka, Burma, Thailand, the Philippines, and Vietnam were probably of the same order of magnitude as the movements from Europe to the Americas. The total labor flows during the first wave of globalization were nearly 10 percent of the world's population.

Global per capita income rose at an unprecedented rate, but not fast enough to prevent the number of poor people from rising. Among the globalizing countries there was convergence in income per capita, driven primarily by migration. However, there was a widening gap between the globalizers and those countries left behind, leading to increased world inequality.

A century ago globalization seemed as inevitable as it does today. However, incompetent economic policies, unemployment and nationalism drove governments into beggar-thy-neighbor protectionism. In retrospect, we can see the period encompassing the First World War, the Great Depression, and the Second World War as a giant step backward in global economic integration. By the late 1940s trade as a share of income was approximately back to its level of 1870: protectionism had erased 80 years of progress in transportation. During this period of inward-looking economic policies global growth slowed down: the growth of per capita income fell by around a third, and the number of poor people continued to rise. World inequality continued to increase; protectionism was clearly not equalizing. Despite the rise in poverty viewed in terms of income, this was a period of great advances in life expectancy due to the global spread of improvements in public health. This illustrates both that poverty is multidimensional and that not all its aspects are determined by economic performance.

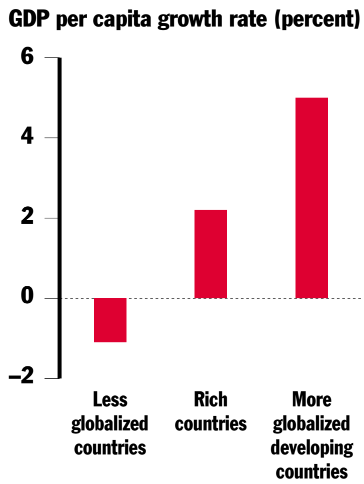
The years from 1950 to 1980 saw a second wave of globalization, one that focused on integration among rich countries. Europe, North America, and Japan concentrated on restoring trade relations through a series of multilateral trade liberalizations under the auspices of the General Agreement on Tariffs and Trade (GATT). During this second wave most developing countries remained stuck in primary commodity exporting and were largely isolated from capital flows. In part this was due to their own inward-oriented policies. As a group the Organisation of Economic Co-operation and Development (OECD) economies surged ahead with unprecedented growth rates. There was convergence between them as integration proceeded: the industrial countries that were relatively poor grew fastest. Within most OECD countries there was a modest trend toward greater equality, aided by social welfare policies and programs. Growth in the developing countries also recovered, but less strongly, so the gap between rich and poor countries widened. The number of poor people continued to increase although there were continued gains in life expectancy. There was little net change in the distribution of income among and within developing countries.

The most recent wave of globalization—starting around 1980 and continuing today—has been spurred by technological advance in transport and communications technologies and by the choice of large developing countries to improve their investment climates and to open up to foreign trade and investment. For the first time, poor countries have been able to harness the potential of their abundant labor to break into global markets for manufactured goods and for services. Manufactures rose from less than a quarter of developing country exports in 1980 to more than 80 percent by 1998. Countries that strongly increased their participation in global trade and investment include Brazil, China, Hungary, India, and Mexico. Some 24 developing countries—with 3 billion people—have doubled their ratio of trade to income over the past two decades. The rest of the developing world actually trades less today than it did 20 years ago. The more globalized developing countries have increased their per capita growth rate from 1 percent in the 1960s, to 3 percent in the 1970s, 4 percent in the 1980s, and 5 percent in the 1990s. Their growth rates now substantially exceed those of the rich countries: they are catching up just as during earlier waves of globalization there was convergence among OECD countries (figure 1). While the new globalizers are beginning to catch up, much of the rest of the developing world—with about 2 billion people—is becoming marginalized. Their aggregate growth rate was actually negative in the 1990s.

The accelerated growth of recent globalizers is consistent with other cross-country statistical analyses that find that trade goes hand-in-hand with faster growth. The most that these studies can establish is that more trade is *correlated* with higher growth, and one must be careful about drawing conclusions on causality. Lindert and Williamson (2001b) suggest that: "The doubts that one can retain about each individual study threaten to block our view of the overall forest of evidence. Even though no one study can establish that openness to trade has unambiguously helped the representative Third World economy, the preponderance of evidence supports this conclusion" (pp. 29–30).

A widespread anxiety is that growing integration is leading to heightened inequalities within countries. Usually, this is not the case. Most of the globalizing developing countries have seen only small changes in household inequality, and inequality has declined in such countries as the Philippines and Malaysia. However, there are some important examples that go the other way. In Latin America, due to prior extreme inequalities in educational attainment, global integration has further widened wage inequalities. In China inequality has also risen, but the rise in Chinese inequality is far less problematic. Initially, China was both extremely equal and extremely poor. Domestic liberalization first unleashed rapid growth in rural areas. Since the mid-1980s there has also been rapid growth in urban agglomerations; this has increased inequality as the gap between rural and urban areas has widened. If this increase in inequality in China

Figure 1 Divergent paths of developing countries in the 1990s



Source: Dollar and Kraay (2001b).

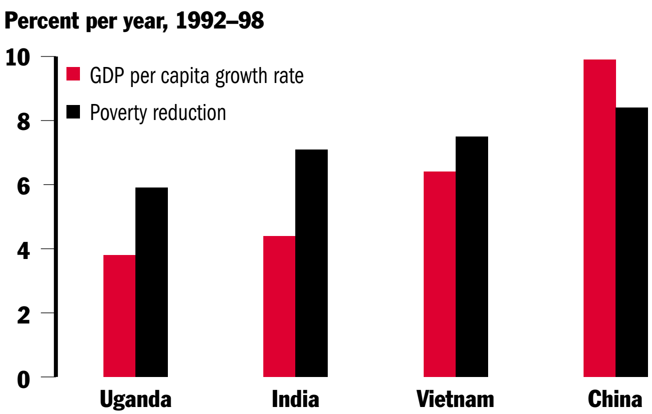
has been the price of growth, it has paid off in terms of a massive reduction in poverty. The number of rural poor in the country declined from 250 million in 1978 to just 34 million in 1999.

The potential for global integration to reduce poverty is well illustrated by the cases of China, India, Uganda, and Vietnam. As Vietnam has integrated it has had a large increase in per capita income and no significant change in inequality. Thus, the income of the poor has risen dramatically and the level of absolute poverty has been cut in half in 10 years. Among the very poorest households, survey evidence shows that 98 percent became better off during the 1990s. This improved well-being is not just a matter of income. Child labor has declined and school enrollment has increased. Vietnam's exports directly provided income-earning opportunities for poor people: exports included labor-intensive products such as footwear and rice, which is produced by most low-income farmers.

India and Uganda also had rapid poverty reduction as they integrated with the global economy (figure 2). While some aspects of the data are controversial, the evidence for substantial poverty reduction in India in the 1990s is strong. In Uganda poverty fell by about 40 percent during the 1990s and school enrollments doubled. Globalization clearly can be a powerful force for poverty reduction.

About 2 billion people live in countries that are not participating strongly in globalization, many of them in Africa and the Former Soviet Union (FSU). Their exports are usually confined to a narrow range of primary

Figure 2 Poverty reduction in Uganda, India, Vietnam, and China closely related to growth



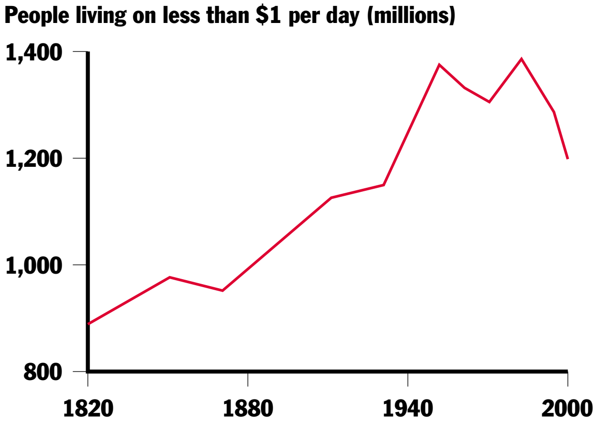
Note: India poverty reduction figure is for 1993–99.
Source: World Bank (2001d); Dollar (2001).

commodities. Such a concentration has made them highly prone to terms of trade shocks. There is also evidence that dependence upon primary commodity exports increases the risk of civil war. Hence, it is important for these countries to diversify their exports by breaking into global markets for manufactured goods and services where possible. Three schools of thought provide credible accounts of why this has not happened. One argues that countries have become marginalized as a result of poor policies and infrastructure, weak institutions, and corrupt governance. The implication is that integration requires not merely openness to trade and investment, but also complementary actions in a wide range of areas. A second school argues that the marginalized countries suffer from intrinsic disadvantages of adverse geography and climate. For example, landlocked countries may simply find it impossible to compete in the markets for global manufactures and services. One implication is that global programs are needed to assist these countries—for example, to counter malaria and to irrigate drought-prone agricultural areas. A third school combines the analysis of the first school with the conclusion of the second. It argues that as a result of a temporary phase of poor policies, some countries have permanently missed the opportunity to industrialize because agglomerations have been located elsewhere in the developing world. All three arguments are probably correct for parts of the marginalized world. However, policy does not have to decide among them. A successful and prudent strategy would combine opening up with the necessary complementary actions, while building the global coalitions needed to address the deep-seated structural problems that face many countries.

The striking divergence between the more globalized and less globalized developing countries since 1980 makes the aggregate performance of developing countries less meaningful. However, since 1980 the overall number of poor people has at last stopped increasing, and has indeed fallen by an estimated 200 million (figure 3). It is falling rapidly in the new globalizers and rising in the rest of the developing world. Non-income dimensions of poverty are also diverging. Life expectancy and schooling are rising in the new globalizers—to levels close to those prevailing in rich countries around 1960. They are falling in parts of Africa and the FSU.

Since 1980 world inequality has also stopped increasing, and may have started to fall. Participation in the world's industrial economy raises incomes, but for about a century only a minority of people participated and so global industrialization led to greater inequality. This third wave of globalization may mark the turning point at which participation has widened sufficiently for it to reduce both poverty and inequality.

Figure 3 World poverty, 1820–1998



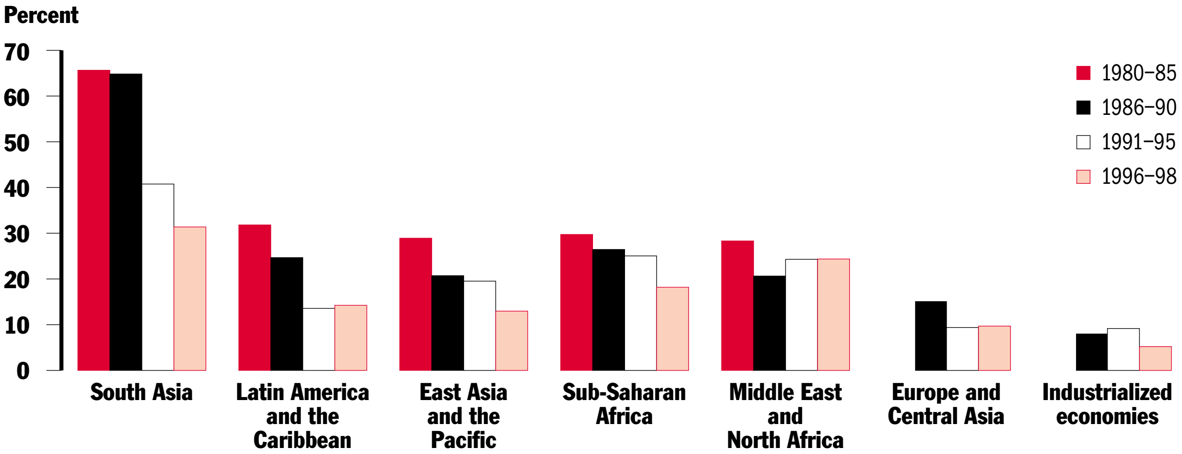
Source: Bourguignon and Morrisson (2001); Chen and Ravallion (2001).

Improving the international architecture for integration

CHAPTER 2 FOCUSES ON THE GLOBAL AGENDA FOR TRADE policy, financial architecture, and migration. A distinctive feature of the current round of globalization is that many developing countries have cut their restrictions on imports in the past 20 years. The reduction in average tariffs is particularly striking in South Asia, from 65 percent in the early 1980s to about 30 percent today (figure 4). In Latin America and East Asia, average rates fell from 30 percent to about 10 percent. On average, liberalization efforts in Sub-Saharan Africa and in the Middle East and North Africa have been more limited, though there are individual countries such as Ethiopia and Uganda that have liberalized trade significantly and pursued other reforms. Most of these moves have been unilateral rather than under the auspices of multilateral negotiations through the GATT or it successor organization, the World Trade Organization (WTO). As countries such as China, India, and Mexico have opened up, their exports have shifted into manufactured products so that they are competing head-to-head with many of the products made in rich countries. In 1980 manufactured products comprised only 25 percent of developing country exports; by 1998 that figure had reached more than 80 percent.

While many developing countries have chosen to become more open economically, they continue to confront protectionism in the rich

Figure 4 Average unweighted tariff rates by region



Source: World Bank (2001c).

countries. Average tariff rates in rich countries are low, but they maintain barriers in exactly the areas where developing countries have comparative advantage: agriculture and labor-intensive manufactures. Protection in rich countries costs developing countries more than $100 billion per year, twice the total volume of aid from North to South. Barriers in developing countries are three times higher than in OECD countries. Given that developing countries now trade much more with each other than in the past, and 70 percent of the tariff barriers on developing country exports come from other developing countries, there would be significant gains from another round of multilateral trade liberalization within the framework of the WTO.

A "development round" of trade liberalization should focus on improving market access of developing countries to rich country markets and to each other's markets. However, such a "development round" is threatened by narrow protectionist interests in the North. Protectionists are seeking to load up the trade agenda with a host of other, institutional development issues. If the rich countries insist on institutional harmonization in areas such as intellectual property rights and standards for health, labor, and the environment as a prerequisite for market access, then prospects for greater trade between North and South will be greatly diminished. This report argues that many developing countries *are* strengthening labor conditions and environmental policies and that there is much more that the world can do in support. The threat of trade sanctions through the WTO is not supportive but destructive. What is needed is greater support for *domestic* actions to improve labor and environmental outcomes.

Hand-in-hand with trade liberalization, developing countries have reduced restrictions on foreign investment. Private capital flows to developing countries—especially foreign direct investment (FDI)—have soared. These flows bring benefits: increased supply of capital and access to technology, management, and markets. While private flows to the new globalizers have risen dramatically, the less globalized countries have often experienced capital flight—by 1990 about 40 percent of Africa's private wealth was held outside the continent. Further, official development assistance from rich countries to poor ones has declined. For the poor locations that do not now benefit greatly from globalization, there is a need for more aid, better managed.

While there are large and clear benefits from reducing trade barriers, exposure to world capital markets carries both benefits and considerable risks. Countries need good institutions and policies for strong and sustained benefits from financial integration. Without a sound domestic financial system, integration with global capital markets can lead to disastrous results, as it did in Thailand, Indonesia, and the Republic of Korea in 1997. Foreign investment in financial and accounting services can help with the needed strengthening. Even with the best of institutions and policies, countries can be buffeted by international financial crises because these markets are subject to irrational boom and bust cycles. Better international coordination is needed on accounting standards and transparency and on the management of incipient financial crises in such a way that adequate liquidity is ensured for countries with sound policies while at the same time private investors are discouraged from and penalized for risky lending practices.

Migration is the third main global flow. The role of migration is connected to the importance of geography. In regions with poor institutions and high transport costs wages will be low, and free movement of goods and capital will not bring those wages into line with wages in good locations. Further, within good locations there will be clustering as long as agglomeration economies are important, and hence wage pressure to migrate to towns and cities.

We noted above that during the first great wave of globalization about 10 percent of the world's population moved permanently to a new country. Even greater numbers migrated from rural areas to cities within countries. The same forces operate today. A study following individual, legal migrants from Mexico to the United States found that on average they left jobs at home paying $31 per week and on arrival in the United States could immediately earn $278 per week (a nine-fold increase). Similarly, Indonesian workers earn 28 cents per day at home, compared to $2 or more in next-door Malaysia. Clearly there are huge real gains to individual workers who migrate to more developed economies.

While economic pressures for migration are strong, legal migration is highly restricted. Compared to 100 years ago, the world is much less globalized when it comes to labor flows. The total number of migrants living in countries not of their citizenship is only about 2 percent of the world's population. At the same time, pressures for migration are mounting. The labor force in OECD countries is aging, while the labor force in the developing world is surging because of high birth rates. Each year 83 million people are added to world population, 82 million of them in developing countries. In Japan and the European Union (EU), the ratio of workers to retirees will decline from five to one today to three to one in 2015, without greater migration. That will put a strain on social security systems.

Potentially, there is mutual economic benefit in combining the capital and technology of the OECD countries with the labor of the developing world. To some extent that can occur through the flow of capital and production to developing countries. But geographic factors make it unlikely that capital flows and trade will eliminate the economic rationale for migration. Too many parts of the developing world have poor institutions and infrastructure that will not attract production; at the same time, some of the existing production networks in the North are too deeply rooted to move. Institutional and policy reform and infrastructure investments in lagging developing countries could address the first concern and reduce, though not eliminate, economic pressures for migration.

The experiences of Mexico and the United States illustrate how migration can be a positive factor for both economies. About 7 million Mexican citizens are living legally in the United States, along with an estimated additional 3 million undocumented Mexican workers. This represents about 10 percent of Mexico's population and an even larger share of the Mexican labor force. Their work in the United States takes pressure off the Mexican labor market (raising wages there) and leads to a significant flow of remittances to relatives back home. In the United States, this labor inflow was a key factor contributing to sustained growth with low inflation in the 1990s. However, migration into the United States is estimated to have reduced the relative wage of unskilled workers by 5 percent, once again demonstrating that globalization typically produces winners and losers.

OECD countries are in general highly restrictive about migration, and they tend to discriminate in favor of educated workers (leading to a so-called "brain drain" from developing countries). Labor flows would make a greater contribution to poverty reduction if immigration policies were more neutral and allowed more unskilled workers to immigrate.

Strengthening domestic institutions and policies

INTEGRATION IS NOT PRIMARILY THE RESULT OF TRADE policy. It is also affected by a host of other institutions and policies. Chapter 3 focuses on this agenda. Countries such as China, India, and Mexico have taken different approaches to integration. There are common issues that must be addressed, but different institutional arrangements and policies for tackling them. Two of the important issues that need to be faced are the investment climate and social protection for workers.

Firms in open economies face more competition. Competition brings many good effects, but there is more entry and exit of firms—"churning"—than in relatively closed economies. Studies of Chile, Colombia, and Morocco after liberalization found that one-quarter to one-third of manufacturing firms turned over in a typical four-year period. Recent evidence from surveys of firms shows that it is unusual for manufacturing plants to shift from domestic production to exporting. For example, three-quarters of exporting plants in Morocco had exported from their first year of operation. Thus, the process of integrating into world markets is likely to require the opening of new plants and the closure of others.

Chapter 3 highlights other stylized facts about domestic firms in open economies. First, while production often becomes more concentrated (leading to fewer firms), the presence of imports leads to a more competitive market and lower price-cost mark-ups. Second, there is some evidence of technology spillovers from foreign trade and investment raising the productivity of domestic firms. Third, there can be learning and threshold effects of exporting that create a better environment for productivity growth of domestic firms.

Individual cases and firm-level studies reveal that developing country firms can be competitive. However, they are often hampered by a poor investment climate—including inefficient regulation, corruption, infrastructure weaknesses, and poor financial services. A recent study of India concludes that it is possible to measure the quality of the investment climate through firm surveys and that this climate is important. With the same trade and macro policies (which are national level), Indian states are getting widely different results from liberalization. "Good climate" states have more efficient regulation and better infrastructure (the typical small enterprise is using the Internet to do business), while "poor climate" states lag behind. Not surprisingly, the states with good climates are getting both more domestic and more foreign investment.

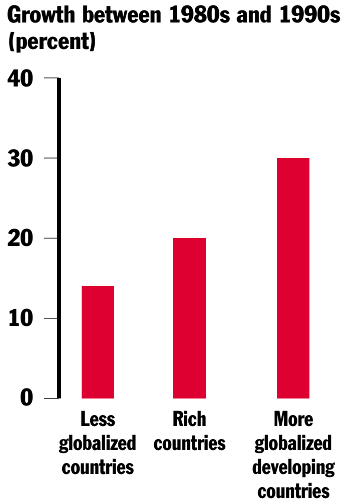
Thus, locations within the developing world that are benefiting strongly from globalization have created a reasonably good investment climate in which firms can start up and prosper (and exit if they are not successful). Coastal China and northern Mexico are other examples, and here too poverty reduction is quite strong.

Small and medium-sized firms suffer from a poor investment climate even more than the bigger firms. Further, we should emphasize that a good investment climate is crucial for the development of rural as well as urban areas. Off-farm employment is a crucial element in raising rural incomes, and farming suffers just as much from a weak investment climate as other productive activities.

Many of the regions that did not participate strongly in the global economy in the 1990s had problems with property rights and overall investment climate. Burma, Nigeria, Pakistan, the Russian Federation, and the Indian state of Uttar Pradesh are examples. These locations could use the international market for services (such as banking, telecommunications, and power) to improve their investment climates. The successful locations have devised their own solutions. China, India, and Mexico have all taken different approaches to opening up, suited to their own circumstances. This diversity of experience among successful globalizers is one reason why any efforts to promote institutional harmonization should take careful account of differing circumstances. They should not be linked to trade agreements in any mechanical or formulaic way.

Together with greater "churning" of firms comes higher labor market turnover, which can be one of the most disruptive aspects of global economic integration. In the long run workers gain from integration. Wages have grown twice as fast in the more globalized developing countries than in the less globalized ones, and faster than in rich countries as well (figure 5). The short-run effects, however, can be quite different. There

Figure 5 Wage growth by country group



Source: Freeman, Oostendorp, and Rama (2001).

is evidence that the wages of formal sector workers are reduced by trade openness and increased by direct foreign investment. Thus, in an economy that liberalizes trade and gets little foreign investment (either because the investment climate is weak or simply because there is a lagged response of investors), opening up can lead to temporary declines in formal sector wages.

There is also evidence that openness—especially to FDI—increases the return to education and raises the skill premium (the extra pay that skilled workers get relative to unskilled workers). Case studies of transition economies and Latin America have found that skill premiums increase after liberalization. Trade liberalization in Costa Rica led to higher demand and higher wages for more skilled workers. After liberalization in Brazil there was a higher return to workers with a college education and a decreased return to those with intermediate levels of education. These findings highlight the importance of complementary policies both for social protection (to help with temporary unemployment) and for education. An increased skill premium can be a good thing because it encourages more investment in education. However, if the education system is not serving all levels of society well, then wages could become even more unequal.

Some of the important losers from globalization will be formal sector workers in protected industries. The adjustment is likely to be especially tough for older workers. Government social protection and labor market policies are very important—both for the immediate welfare of affected workers and for the longer-term welfare of all workers. To get reforms underway may require one-time compensation schemes for workers who would otherwise suffer large losses. Well-designed unemployment insurance and severance pay systems can provide protection to formal sector workers in an environment that will now have more entry and exit of firms. The poorest people cannot be reached by such systems, but there is huge potential to reduce their vulnerability to shocks through self-targeting programs such as food-for-work schemes. Social protection can be a dynamic force for growth and innovation beyond the gaining of acceptance for change—it can be crucial to the ability of poor people to take the risks involved in entrepreneurship. Finally, the combination of openness and a well-educated labor force produces especially good results for poverty reduction and human welfare. Hence, a good education system that provides opportunities for all is critical for success in this globalizing world.

Power, culture, and the environment

SO FAR, WE HAVE FOCUSED ON INCOME, INCOME DISTRIBUTION, and poverty. But much of the anxiety surrounding globalization concerns issues of power, culture, and the environment. Chapter 4 discusses these concerns.

A recent poll of 20,000 people in 20 countries found that by a margin of two to one people thought globalization would materially benefit their families (Environics 2001). (The survey included developing countries such as Brazil, China, India, and Nigeria.) But while people expect the kind of material benefits that we have documented in our report, they also express serious concerns and even fears. More than half of those polled were convinced that globalization threatens their country's unique culture. Citizens also perceive a lack of global governance in important areas. About four in 10 respondents named human rights as the area most in need of stronger international control, while three in 10 said that global environmental action was the highest priority. One in 10 thought that international action on workers' rights was a priority.

The United States is the largest and in some respects the most successful economy on earth, giving millions of poor people, many of them immigrants from developing countries, an opportunity to rise to prosperity. But it is not the only model of success. Several economies match or exceed the American level of income per capita while having radically different policies and more equal social outcomes. For example, Austria, Belgium, Denmark, Japan, and Norway are open economies. All have far less inequality than the United States with similar average income. By combining prosperity with equity they are the closest the world has yet come to eradicating poverty. Voters in the United States and these five countries have chosen substantially different models, all of which work given their respective histories. Not only is there no ultimate model of success, there is no fixed formula for reaching success. China, India, and Mexico all globalized during the 1990s as a result of far-reaching reform programs, but the content of these programs has differed.

Culturally, as societies integrate, in many respects they become more diverse: Ikea has brought Swedish design to Russians, co-existing with Russian design; Indian immigrants and McDonald's have brought chicken tikka and hamburgers to Britain, co-existing with fish and chips. However, without policies to foster local and other cultural traditions, globalization may indeed lead to a dominance of American culture.

In most developing countries the state is smaller relative to national income than in either the United States or the five high-income, high-equity countries noted above. Successful globalization—on any of these models—usually *enlarges* the state, both absolutely and relatively. However, globalization weakens some aspects of government, making some policy instruments ineffective.

Globalization will usually *weaken* monopolies. As countries open their markets, national monopoly producers face competition from foreign firms. However, one firm will occasionally get a sufficiently large global technological advantage that it acquires a temporary global monopoly, and more commonly oligopolies exert global market power. Such cases pose severe challenges to national anti-trust regulators. Further, there are charges that in developing countries some foreign firms may lobby or bribe to gain special privileges, for example, in telecommunications or minerals.

As global trade becomes more firmly based upon a legal framework, this potentially enhances the power of the developing countries: the weak need rules more than the strong. However, there is a danger that the rules come to favor the strong. For example, rich and poor countries have somewhat different interests regarding intellectual property and global warming. Developing countries want to keep some knowledge as a public good, while industrial countries prefer to turn it into a private good in order to reward innovation. Developing countries will suffer most from global warming, while rich countries are generating most of the carbon dioxide (CO_2) that is causing the problem. In bargaining to achieve fair rules on such issues, poor countries are handicapped by both their poverty and their fragmentation.

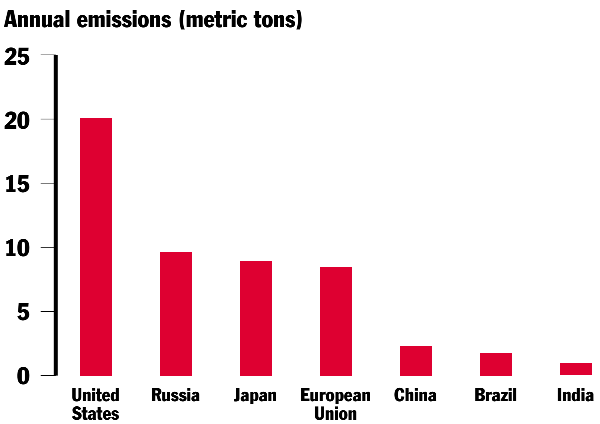
Globalization does not have to undermine national and local environmental standards through a so-called race to the bottom. Despite widespread fears, there is no evidence of a decline in environmental standards. In fact, a recent study of air quality in major industrial centers of the new globalizers found that it had improved significantly in all of them. A positive side of globalization is that communities can learn from each other about successful strategies to control pollution. Developing countries usually have serious problems enforcing regulations in the face of powerful vested interests. Indonesia improved compliance dramatically through a program in which environmentally dangerous factories were publicly identified, leading communities to organize against these polluters. Other communities have learned from this example and are introducing similar programs.

As with core labor standards, some groups in the rich countries are proposing that environmental regulations be policed through WTO sanctions. There are better ways to empower local communities. WTO sanctions would carry the risk of being hijacked by protectionist lobbies in rich countries and end up by restricting the opportunities of poor ones.

Some environmental issues, such as global warming, are intrinsically global. They require international cooperation, and the habit of such cooperation is easier in an integrated world. There is broad agreement among scientists that human activity has led to global warming and that much greater climate change is in store unless collective, corrective actions are taken. Where the problem comes from is clear. Seven economies (the so-called E-7) account for 70 percent of CO_2 emissions. The United States, with only 4 percent of the world's population, emits nearly 25 percent of greenhouse gases. China is the second largest emitter, followed by the EU, the Russian Federation, Japan, India, and Brazil. In per capita terms, the United States (with 20 metric tons per capita) is far ahead of other economies in terms of CO_2 emissions (figure 6).

It is important for the world that the major emitting countries agree on a way to reduce greenhouse gases. This is a classic collective action problem in which each country is reluctant to move on its own because much of the benefit of its reduction in greenhouse gases will accrue to others. The Kyoto protocol is an important step forward in collaborative action to address global warming.

Figure 6 Per capita CO_2 emissions in the E-7 economies, 1998



Source: Kraus and Shalizi (2001).

An agenda for action

RECENT GLOBALIZATION HAS BEEN A FORCE FOR POVERTY reduction, and has helped some large poor countries to narrow the gap with rich countries. However, some of the widespread anxieties are well founded: globalization could be much more effective for poor people, and its adverse effects could be substantially reduced. In important respects global policies are not keeping pace with global opportunities and global risks. In our report we propose an agenda for action, both global and local, that could make globalization work better and help countries and people that have been marginalized. In part our agenda overlaps with the agenda of those who protest globalization, but it is diametrically opposed to the nationalism, protectionism, and anti-industrial romanticism that is all too prominent. Our study highlights many actions that could help make globalization more beneficial. Of these, we will emphasize seven that we see as particularly important for making globalization work for the poor.

Participation in an expanding global market has basically been a positive force for growth and poverty reduction in developing countries, which is why so many countries have chosen to become more open to foreign trade and investment. Very significant barriers to trade still remain, however, and a *first* area for action is a "development round" of trade negotiations. A "development round" should focus first and foremost on market access. Rich countries maintain protections in exactly the areas where developing countries have comparative advantage, and there would be large gains to poor countries if these were reduced. Furthermore, developing countries would gain a lot from better access to each other's markets—barriers between them are still higher than those from developed countries. These improvements in access are best negotiated in a multilateral context.

Developing countries have a good argument that trade agreements should not impose labor or environmental standards on poor countries. Communities all over the world are struggling to improve living standards and labor and environmental conditions. There are positive ways that rich countries can support this. A real and positive commitment, however, requires real resources (more below on this). Imposing trade sanctions on countries that do not meet first-world standards for labor and environmental conditions can have deeply damaging effects on the living standards of poor people and for that reason is unconstructive. Furthermore, there is all too much danger that trade sanctions to enforce these standards will become new forms of protectionism that make the poor worse off. The more general point here is that trade agreements should leave countries free to take different institutional approaches to environmental standards, social protection, cultural preservation, and other issues. Among globalized countries there is great diversity of institutions and cultures, and we see no reason why economic integration cannot respect that.

Our research shows that open trade and investment policies are not going to do much for poor countries if other policies are bad. The locations in the developing world that are prospering during this most recent wave of globalization are ones that have created reasonably good investment climates in which firms, particularly small domestic firms, can start up, prosper, and expand. Hence, a *second* key area for action is improving the investment climate in developing countries. A sound investment climate is not one full of tax breaks and subsidies for firms. It is rather an environment of good economic governance—control of corruption, well-functioning bureaucracies and regulation, contract enforcement, and protection of property rights. Connectivity to other markets within a country and globally (through transport and telecommunications infrastructure) is a key part of a good investment climate. A bad investment climate hits agriculture and small firms even harder than bigger firms.

Developing a sound investment climate is primarily a national and local responsibility and should focus particularly on the problems facing small firms. Employment in the small and medium-sized firms in towns and rural areas will be central to raising the living standards of the rural poor. Communities can use foreign investment and the international market for services to strengthen the investment climate. The presence of foreign banks in the local market strengthens the financial infrastructure. With the right incentives, foreign investment can efficiently provide power, ports, telecommunications, and other business services.

The evidence is quite strong that integration with the global market raises the return to education in different types of countries (both rich and poor). The higher return to education can be a positive thing, as it encourages households to invest in their children. But this highlights the importance of good delivery of education and health services—the *third* element in our agenda. If poor people have little or no access to health and education services then it is very hard for them to benefit from the growth spurred by integration. With poor social services, globalization can easily lead to mounting inequality within a country and persistence of extreme poverty. For the newly globalizing developing countries as a group, there has been impressive progress in educational attainment—especially for primary education—and decline in infant mortality, suggesting that many locations have made the complementary investments in social services that are critical to ensure that the poor benefit from growth. The combination of strong education for poor people and a more positive investment climate is critical for empowering poor people to participate in the benefits of a more strongly expanding economy. But empowerment goes much deeper than this. It is about organizing property rights and governance in a way that involves poor people in decisions that affect their lives.

While integration has on average been a positive force for growth and poverty reduction in developing countries, there are inevitably specific winners and losers, especially in the short run. This is true in rich and poor countries. The firm-level evidence shows that much of the dynamic benefit of open trade and investment comes from more "churning" of plants—less efficient ones die, and new ones start up and expand. With this comes more labor market churning as well—probably the key reason why globalization is so controversial. It raises wages on average in both rich and poor countries, but there are some significant losers. Thus, the *fourth* area for action is to provide social protection tailored to the more dynamic labor market in an open economy. This is important to help individual workers who will lose in the short run from opening up, as well as to create a solid social foundation on which households—especially poor ones—feel comfortable taking risks and showing entrepreneurship. We try to document what works in a relatively rich country, and for formal sector workers, and what works in poor countries and for the large number of poor in the informal sector and rural areas. If policymakers do not put workable social protection measures into place, then many individual people will be hurt and the whole integration undertaking becomes suspect.

The *fifth* component of our action program is a greater volume of foreign aid, better managed. Aid should be targeted to a number of different problems. The evidence shows that, when low-income countries reform and improve the investment climate and social services, private investment—both domestic and foreign—responds with a lag. It is precisely in this environment that large-scale aid can have a great impact on growth and poverty reduction. Thus, while creating a sound policy environment is primarily a national and local responsibility, the world can help societies making difficult changes with financial support. Supporting low-income reformers—both at the national level and at the local level—is a key role for aid. Another important role for aid is to address some of the specific health and geographic challenges of marginalized countries and people. We have emphasized that there are locations that face difficult geographic challenges and that policy reform alone is not going to do much in these places. More aid should be targeted to research into health and agricultural technologies that could make a large difference in locations suffering from malaria and other challenges. Beyond research, there is obviously a need for assistance to deliver these health innovations to those who would benefit from them.

Our *sixth* area for action is debt relief. This is a kind of aid, but we do not want our recommendation here to get lost in our more general call for greater aid. Many of the marginalized countries, especially in Africa, are burdened with unsustainable debts. Reducing the debt burdens of these countries will be one factor enabling them to participate more strongly in globalization. Debt relief is particularly powerful when combined with policy reform (improvements in the investment climate and social services). Debt relief should make a significant difference for countries that have reasonably sound policy environments for poverty reduction, as in the Heavily Indebted Poor Country (HIPC) initiative. It is important to put debt relief in the larger context of the overall foreign aid for marginalized countries. Debt relief should not come out of the existing envelope for aid (in which case little of real value will result) but rather needs to be complemented with greater overall volumes of assistance.

The six areas that we have highlighted for policy action on globalization are primarily in the economic realm and aim to raise the income and living standards of poor people. However, our report also examines a wide range of non-economic issues—power, culture, environment—and presents evidence about the effect of globalization on these important issues. We highlight many specific actions that can mitigate the risks and costs of globalization. Here in the action program, the *seventh* measure to highlight is the importance of tackling greenhouse gases and global warming. There is broad agreement among scientists that human activity is leading to climate change and that disastrous global warming is in store unless collective, corrective action is taken. This is one example of a critical area in which there a lack of effective global cooperation at this point. It is also one of the global problems that is going to particularly burden poor countries and poor people if it is not addressed.

The falling costs of communications, information, and transport that have contributed to globalization will not be reversed, but the reduction in trade and investment barriers could be reversed by protectionism and nationalism—as happened in the 1930s. However, protectionism and nationalism would be a profoundly damaging reaction to the challenges created by globalization. The problems must be addressed, but they are manageable. The reasonable concerns about globalization can be met without sacrificing the potential for global economic integration to dramatically benefit poor countries and poor people. Many poor people are benefiting from globalization. The challenge is to bring more of them into this process, not to retreat to the insularity and nationalism of the 1930s.