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What may constitute an equal Society? Addressing externalities of globalization

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Abstract. This paper is a short review of Mamoon (2007) analysis on inequality where it is contrasted with growth. The economic processes or institutional dynamics that are good for growth may not be a priority if inequalities are the prime consideration. For example rule of law and control for corruption are the most salient factors to mitigate inequality but though they are also good for growth, it is good regulation that takes the lead in growth promotion. China has been benefitting from good market regulation - a pro capitalist economic tool kit while suffering from rising inequality that may be due to less emphasis on control for corruption.
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1. Introduction

The problem of poverty can not be separated from the way in which growth is achieved. Hence, today the principle issue in pro poor growth debate also relates to inequality. Recent literature suggests that international trade and strong institutions are the key determinants of growth (i.e, see Dollar & Kraay, 2003; Rodrik *et. al.,* 2004; Glaeser *et. al.,* 2004a, Mamoon & Murshed, 2005). It is important to look at the different institutional setups; countries may have while working along with the surge of globalization. For example, India is a thriving democracy but China, South Korea and Taiwan have been growing under one-party dictatorships, the last two eventually turning to democracy. Recently, Pakistan has become one of the fastest growing economies of the region, even surpassing India, under the one man rule of General Musharraf. Among the transition economies, rapid economic growth was achieved by Kazakhastan under Nazarbaev. Here one may conveniently assume that these countries have performed well under market friendly policies and thus successfully achieved robust economic performance. However the analogy is not that simple. Market friendly policies may not work in the absence of good institutions. The failure of Russian economy and its reform process can be attributed to the lack of a supportive legal, regulatory and political apparatus. In Latin America little attention has been paid to the mechanisms of social insurance and to the safety nets which has resulted in the dissatisfaction with market oriented reforms. It may also be the case that some institutions may be more important than others. For example, even pro-market dictators can secure property rights as a matter of policy choice (Glaeser, 2004a). Similarly, stronger social institutions lead to improved government functioning: "Education is needed for courts to operate and to empower citizens to engage with government institutions (Ibid, 2004: 3)".

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Partly due to the recession in the 1980s, which hit the poor harder than the rich, inequality in most Latin American states except for three (Colombia, Uruguay and Costa Rica) witness sharp rises. Gini coefficients in Latin America have been ranged between 0.45 and 0.60 since early 1950s, which are among the highest in the world. The sharp income dispersion has been rooted in a highly unequal distribution of land and educational opportunities (Cornia *et. al.,* 2004).

In China income concentration has been rising rapidly since 1985 so that the Gini coefficient reached 0.43 by 1995 and remained more or less at the same level until recently. The rise in income disparity can be attributed to a rise in urban-rural divide arising from a faster expansion of urban activities amid active participation of China in international markets. Among South East Asian economies, the Gini coefficient for Indonesia increased to 0.38 by 1997 from 0.32 in 1987-90. In South Asia, inequality also followed a U-shaped pattern, though it was less pronounced. In India, the experience of 1990s points to a moderate rise in both urban and rural inequality and a larger rise in overall inequality due to widening gap between urban and rural areas. In 1990s the urban inequality rose to 0.36. The Gini coefficient in Pakistan rose from 0.39 in 1960s to 0.41 in 1990s. Much like India, the rise in overall inequality is attributed to a sharp rise in rural inequalities. Inequality in Sub Saharan Africa has been among the highest in world. There is some evidence of falling urban-rural gap but there is rising intra urban and at times intra rural inequalities. For example, in Tanzania the Gini coefficient for rural inequality rose from 0.53 in early 1980s to 0.76 in early 1990s. Similarly for Kenya, the rural inequalities increased by 9 points from 1980 to 1992 and stand at 0.49 (Ibid, 2004).

2. Inequality and the inter-dependency factors

Many recent studies (i.e., see Chen & Ravallion, 2003; Cockburn, 2002; Friedman, 2000; Lofgren, 1999) show that international trade is significantly related with inequality while institutions and integration are also endogenous (i.e., Rodrik *et. al.,* 2004). Any empirical analysis which takes institutions as a pure exogenous factor while analysing its effects on inequality may lead to miss-specification bias. Here on the line of Rodrik *et. al.,* (2004), we assume geography is a pure endogenous concept.

Chong & Gradstein (2004) find strong evidence of bi-directional causality between institutions and inequality. Inequality may affect the quality of institutions. For example, high inequality will prevent the poor from investing in education or the ruling class may not invest in education so that the poor majority will not be politically active thus undermining the development of necessary social and political institutions. Keefer & Knack (2002) suggests that social polarisation negatively affects institutional quality.

The countries with poor institutions are also likely to have high inequality. For example in Russia in the 1990s, a small group of entrepreneurs exploited their political power to promote their own interests, subverting the emergence of institutions committed to the protection of smaller share holders and businesses. According to the Corruption Perceptions Index published by Transparency International, among the transition economies, Estonia is placed 28, and Hungary 31; whereas Russia is placed 79, and Ukraine 83. In these transition economies, weak performance of public institutions, infringement of property rights in favour of influential parties, lower willingness to use courts to resolve business disputes, lower level of tax compliance and higher levels of bribery all have been strongly correlated with inequality (Hellman & Kaufman, 2002). Similarly, in several Latin American countries, the ruling elites, the military and large businesses impeded smaller business interests giving rise to significant informal sector. Chong & Gradstein (2004) show that when the political bias in favour of the rich is large, income inequality and poor institutional quality may reinforce each other, indicating endogeniety between the two.

There may also be inter-linkages between various institutions. For example, nearly all developed countries are democracies and most developing countries are either run under one party system, dictatorships or military regimes. The countries with lower levels of economic and human development tend to have lower levels of education, limited political rights, weak or non existent political competition, lower level of economic freedom and openness, ethno linguistic factionalism, the lack of judicial independence and a free press and high levels of permissiveness towards corruption.

Institutions can be differentiated into four distinct categories: 1) Legal, 2) Political, 3) Economic and 4) Social. Legal institutions capture the transparency and fairness of legal system, political rights of the citizens, State legitimacy, freedom of speech, independence of judiciary, enforceability of contracts, police effectiveness, access to independent and impartial courts, confidence in judicial system in insuring property rights, prevention of improper practices in public sphere, control of corruption etc. Political institutions represent political stability, democracy, autocracy or dictatorship. Economic institutions include state effectiveness at collecting taxes or other forms of government revenue, states ability to create, deliver and maintain vital national infrastructure, states ability to respond effectively to domestic economic problems, independence of government economic policies from pressure from special interest groups, trade and foreign exchange system, competition policy, privatisation, banking reform and interest rate liberalisation, securities market and non bank financial institutions etc. Social Institutions capture socio economic conditions such as health, education and nutrition etc.

The Legal, political, economic and social institutions are strong in developed countries and for developing countries there are mixed experiences. For example, intellectual property rights are protected vigorously in the US and most advanced societies, but not in many developing countries (Rodrik, 1999). Engerman & Sokoloff (2002) link the development of public education as a social institution to the democratization as a political process in US. According to them, while starting at about the similar level of development in the 18nth century, US led the way in setting up a system of common schools and promoting literacy, where as in countries in South America and the Caribbean these processes were much delayed. Gupta *et. al.,* (1998) finds that if government officials use their authority for private gain and indulge in corruption that affects the effectiveness of social spending and the formation of human capital by perpetuating an unequal distribution of asset ownership and unequal access to education. Corruption also affects the government effectiveness as it weakens tax administration and can lead to tax evasion and improper tax evasion and improper tax exemptions. Higher corruption is associated with increases in inequalities in education, land distribution and health spending. Wealthy urban elites can lobby the government to bias social expenditure toward higher education and tertiary health, which tend to benefit high income groups (Ibid, 1998).

Furthermore, trade opening in societies with weak institutions may lead to worse economic policies. For example, those transition economies where trade reforms were implemented slowly and the government institutions were able to perform well with time, smaller increase in inequality and smaller output decline is occurred. However, the transition economies with weak government setups have performed as 'passive globalizers' and the trade-to-GDP ratios in them were quite high, partly accounting for capital flight, while poverty and inequality was increased (Yudaeva, 2002).

3. What do we find?

Mamoon (2007) examines how legal, economic, political and social institutions fare with different measures of inequality in a cross section framework. Among legal institutions, rule of law and control for corruption have a stronger impact on inequality than voice and accountability. We find that countries which practice democracy are less prone to unequal outcomes especially when it comes to wage inequality and income inequality whereas autocracy is associated with higher level of wage inequalities but its impact on income inequalities are insignificant. Though under good economic management, autocracies may redistribute incomes from the richest to the poorest, more generally an autocratic set up violates the median voter hypothesis.

The results also show that political stability is more sensitive to inequalities than democracy and autocracy which is to say that the countries which are politically stable also form more equal societies. Though in a cross section analysis, our results indicate average sample characteristics of countries chosen which neutralise the single country case sensitivities and thus may have captured the simple observational analogy that most democracies in the world are also the ones which are politically stable and economically efficient whereas most autocracies, unless they are lead by enlightened leadership eventually suffer from unstable or repressed political systems. Economic institutions also play an important role in alleviating global inequalities. Whether the government is functioning effectively and whether it has a robust fiscal and monetary policy seems to have stronger impact on inequality than regulatory quality. Education for all, a proxy for social institutions, has a strong redistributive power. If education is more equally distributed among the population, relative wages of skilled and unskilled labour will have least amount of distortions especially when the country opens up to international trade. Overall, political stability, control for corruption and rule of law trumps any other institutional proxy in reducing inequalities in a country. On the other hand, middle income group is most likely to benefit from good functioning institutions than any other income group.

Regarding integration the paper finds that openness is generally related with higher wage inequality, though its impact on income inequality is insignificant at best. This result is also in line with recent literature. However we also find that level of openness or trade policies may carry significant positive effects in widening the wage gaps between skilled and unskilled labour. The reason for the continuous failure of WTO talks has also been supported by our study as our results show that opening up of protected sectors to increased international competition by revoking import taxes lead to higher wage inequality. The paper recommends more regional trade where by developing countries trade among each other if due to protection their exporting capabilities to the developed countries have been strangled especially in case of agriculture produce. For example, in countries like China and India, the pace of development suggests that both countries are fast climbing the technology ladder and would form significant pockets of services sector oriented high technology dependent production areas which may draw similarities with developed nations in both supply and demand and relative factor prices. Trade within developing countries may seek to exploit such emerging pockets. Countries like Pakistan may also increasingly join in if regional economics is put on priority and conflict of interest are resolved or set aside for preparing economic grounds for social harmony within their populations.

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