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Do liberalization and globalization increase income inequality?

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ABSTRACT

Using the Standardized World Income Inequality Database, we examine if the KOF Index of Globalization and the Economic Freedom Index of the Fraser institute are related to within-country income inequality using panel data covering around 80 countries 1970–2005. Freedom to trade internationally is robustly related to inequality, also when adding several control variables and controlling for potential endogeneity using GMM. Social globalization and deregulation is also linked to inequality. Reforms towards economic freedom seem to increase inequality mainly in rich countries, and social globalization is more important in less developed countries. Monetary reforms, legal reforms and political globalization do not increase inequality.

1. Introduction

Over the past 30 years, most countries around the world have experienced substantial increases in economic freedom and globalization. There is a prevalent belief that such changes may benefit economic growth, but at the expense of increased income inequality within countries. Regarding the first issue, the current consensus among researchers seems to be that economic freedom and globalization are indeed linked to economic growth (see, e.g., Berggren and Jordahl, 2005; Doucouliagos and Ulubasoglu, 2006, and Dreher, 2006).[2]

This paper examines the second question: are increases in economic freedom and globalization, sometimes broadly referred to as liberalization, associated with increasing income inequality within countries? Although participants in public debate on this topic generally have a clear opinion on the relationships, empirical evidence is surprisingly contradictory (cf. Berggren, 1999; Scully, 2002; Carter, 2007; Dreher and Gaston, 2008). Knowledge is limited as to whether all types of liberalization and globalization have similar impacts on income distributions. Due to previous data limitations, empirical studies have also neglected the issue of how different dimensions of economic freedom and globalization influence income inequality at different

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[2] It should be noted, however, that the proper measurement of globalization or liberalization and the direction of the causality in question are still subject to intense debate; see, for example, Rodriguez and Rodrik (1999) and the response of Lee Ha et al. (2004).

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development levels. Using Gini coefficients of household net income from Solt's (2008) recently developed Standardized World Income Inequality Database (SWIID) as our preferred inequality measure, we can construct a panel from 1970 through 2005 with more observations on within-country income inequality than do other studies in this area. This setup also allows for a rigorous analysis of the differential impact across rich and poor contexts and for the use of sophisticated techniques to handle possible endogeneity problems. To quantify globalization and economic freedom, we use the KOF Index of Globalization (KOF), developed and first used by Dreher (2006), and the Economic Freedom of the World Index (EFI) of Gwartney et al. (2008). We make use of the fact that both indices consist of several dimensions, allowing for an analysis of the impact of different types of liberalization and globalization on income inequality.

By estimating a fixed-effect model of country-level income inequality as a function of the KOF and EFI indices, and employing a battery of robustness tests, our analysis arrives at several findings. First, the analysis supports the notion that policy reforms favoring trade openness have on average increased income inequality in recent decades. Exploring the relationship at different levels of development, however, indicates that, in line with theoretical predictions, this significant relationship only appears in middle- and high-income contexts. Second, findings repeatedly also indicate that policy reforms promoting deregulation and social globalization on average have a non-equalizing distributional impact. Moreover, the coefficient of economic globalization is positive, but is sensitive to the exclusion of certain countries from the sample. Third, in estimating a dynamic model, consistent in the case of endogenous variables (Arellano and Bover, 1995; Blundell and Bond, 1998), we again confirm that trade liberalization and economic globalization increase income inequality.

2. Theoretical expectations and related literature

2.1. The different dimensions of economic freedom and globalization

The Economic Freedom of the World Index (EFI) is a composite index that weighs together five dimensions of economic freedom, EFI1–EFI5, which are in turn based on several indicators.

2.1.1. Size of government (EFI1)

The first dimension of the EFI measures government size using indicators such as public consumption and transfers relative to GDP. It also includes top marginal tax rates and state-owned enterprises. The index is coded so that bigger government means a lower economic freedom value in this dimension.

Theoretically, there are reasons to expect states with larger welfare systems to have lower income inequality, as public sector transfers are often assumed to have equalizing effects (see e.g., Rothstein, 1998; Åberg, 1989). The welfare state may also stimulate risky but profitable income-equalizing activities such as education, as people are more likely to engage in such activities when enjoying some protection provided by the welfare state (Sinn, 1995). Evidence also suggests that the welfare state is particularly beneficial to the middle class (see, e.g., Bergh (2007) and Le Grand and Winter (1986)), again suggesting a more compressed income distribution.

Importantly, bigger government, as measured by the index, does not necessarily imply a larger welfare state. In poor countries, where government may be corrupt or even predatory, a smaller government may not increase income inequality at all. A study by Odedokun and Round (2004) examining the relationship between government size and income inequality in 35 African countries supports this view. Following the above, we hypothesize that an increase in EFI1 will have a non-equalizing effect on the within-country income distribution and that this effect will be larger in richer than poorer contexts.

2.1.2. Legal structure and security of property rights (EFI2)

The second dimension of the EFI quantifies the quality and integrity of the legal system and the protection of property rights. This dimension can be thought of as an attempt to quantify rule of law.

It seems intuitive that better protection of property rights should mainly benefit those with more property, as this protection increases tenure security for the owner, which in turn is expected to increase the value of the property itself. However, several scholars suggest the opposite. Inspired by the Russian oligarchs of the 1990s, Sonin (2003) notes that poor protection of property rights may actually be relatively more beneficial to those already rich, resulting in greater inequality. In many developing countries, elites are rich because of corruption and inefficient property rights, and improvements in the legal system may actually be relatively more important for less privileged groups, thereby reducing inequality, as described by, for example, De Soto (2000). Accordingly, we should not be surprised if better protection of property rights is associated with lower inequality.

2.1.3. Access to sound money (EFI3)

The sound money dimension of the EFI captures the effect of large and unpredictable changes in inflation and money supply. This component is coded so that the greater the unpredicted inflation, the lower the value.

The literature on the cost of inflation presents various mechanisms by which inflation could affect income distribution, in particular through returns to capital. High inflation is expected to be relatively more harmful to low-income earners, whose assets are less protected against inflation, increasing income inequality. Moreover, unanticipated inflation may also lead to resource misallocation and to the absorption of considerable resources in information gathering, in an attempt to mitigate the uncertainty of future price levels (Fischer and Modigliani, 1978). This will have negative welfare effects that will reduce the possibility of progressive redistribution.