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Comments on Chapter 7

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'Trade Liberalization, Foreign Direct Investment and Income Inequality' by Professor Giovanni Andrea Cornia is an important contribution to our understanding of the present dynamics of the world income distribution. In it, Professor Cornia demonstrates that there is strong evidence to support the view that there has been a widespread pattern of rising income inequality within countries in the recent period. Building on Cornia and Kiiski (2001) he demonstrates that analysis of reliable observations of income inequality leads unavoidably to such a conclusion. This finding is in itself of great significance and deserves considerably more attention than it has thus far received.

As Cornia notes, within-country inequalities are more central to the experience of the majority of people than between-country inequalities, and are deserving of special attention from that standpoint. Of course, this does not make within-country inequalities necessarily more *morally salient* then between-country inequalities. There is a strong case to be made that the place of one's birth (as is the family into which one is born) is among the

most morally arbitrary and yet crucial determinants of life chances. For this reason, inequalities in advantages that derive from one's place on earth demand moral scrutiny and, potentially, compensatory action.

The evidence concerning the trend of relative inequalities between countries is however more ambiguous than is the trend within countries. Professor Cornia heroically surveys the recent literature on the issue, and comes (as he necessarily must) to a mixed conclusion. It is my view that the methodological complexities involved in undertaking inter-country comparisons of real income are much deeper than are recognized in the current literature, as a result of which, taken as a whole, that literature lacks in credibility and conclusiveness. In addition to the limitations (in quantity and quality) of the data on within-country income distributions (which are necessary to construct a world income distribution) there are deep limitations in existing 'Purchasing Power Parity' (PPP) conversion factors which make the application in income distribution analysis ill-advised, and which cause the resulting analyses to lack in an adequate conceptual foundation.

Existing PPPs cannot be interpreted as relating to the purchasing power necessary to maintain fixed command over commodities, capabilities or utilities (or any other evaluative standard) in an adequately robust way. In particular, attempts to interpret existing PPPs along these lines break down when faced with heterogeneity of agents, changing world consumption patterns, and income effects, all of which are necessary to admit from the standpoint of realism. Quite apart from these conceptual difficulties, many of the studies surveyed by Professor Cornia have used PPPs (such as those relating to GDP or consumption aggregates from the Penn World Tables) that are highly inappropriate for comparative living standards assessment, as the motivation underlying their production has been to create internationally comparable national income accounts rather than to permit meaningful living standards comparisons.

The PPPs used by all of the studies are imprecise for a host of reasons (notably the lack of confidence in the estimates of PPPs for India and China, on which the picture of the global income distribution substantially depends). As a result, it is currently impossible to have confidence that the picture of world income distribution offered by any of the studies surveyed is precise or meaningful. Current estimates of world inequality are predicated on a mistaken conception that what is being measured is conceptually clear, that the measures produced correspond to a relevant reality, and that they are being generated with adequate precision. Each of these premises is false, and to a rather embarrassing degree. It would therefore be premature and foolhardy to venture strong claims about the trend of world income distribution. All that seems certain is that there is a great deal of inequality in the world, and indeed far too much for complacency.

Professor Cornia goes on to survey the literature on the relationship between trade and inequality, and that on the relationship between Foreign

Direct Investment (FDI) and inequality. He convincingly establishes that there are theoretical grounds for concluding that both trade and FDI can potentially increase domestic inequalities. He shows that there is also sufficient empirical evidence in this direction that it is necessary to judge (at least for the moment) that the effects of both international trade and FDI on domestic inequality appear to be at best mixed. An issue that he does not consider, and which would be emphasized by advocates of external market liberalization, is the potential role of both trade and FDI in reducing between-country income differentials. The effect of the liberalization of trade and investment on world income inequalities is a composite of its effects on between-country and within-country inequalities. Although neither of these effects is easy to chart, it is important to take note that their consequences for world income inequality may well be conflicting.

Returning to the evidence of rising income inequality within countries cited early in the chapter, Professor Cornia raises the question of what factors are responsible. He quite reasonably rejects the hypotheses that either the traditional causes of inequality or the widely favoured 'Deus ex machina' of technological change account for the widely observed phenomena of rising domestic inequality. Professor Cornia accordingly places the focus on the role of the 'paradigmatic shift of the last 20 years'. The focus on the role of policy reforms does indeed seem entirely appropriate. As Professor Cornia recognizes, however, a causal explanation at this level of abstraction is not in itself especially illuminating. It is necessary to identify the specific policy reforms that are most responsible for rising inequalities, if appropriate policy responses are to be formulated. It is my own suspicion that those policy reforms that undermined the capacity of the state to generate revenues and to undertake expenditures of a more progressive type are the ones that have had the largest tendency to increase income inequalities. The role of labour market reforms, privatization, and capital market liberalization has no doubt also been very significant. The role of trade is likely to have been secondary. It would be of immense value if the research that Professor Cornia has presented in this chapter were followed by as convincing an identification of the specific causes of rising inequalities within countries. Research that illuminates this question is urgent, as it is directly relevant to answering the recurrent question, 'What is to be done?'. In particular, it can help developing countries (DCs) to identify a path of policy reforms that takes advantage of the economic opportunities offered by international integration, while better avoiding the pitfalls that have so often been a consequence of the choices made in the last two decades.

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