Edexcel

A Level

Economics

(Code: WEC11 01)

Unit 04-Section 1

Causes and effects of globalization

Chapter 21 – Characteristics and causes for globalization

THE CHARACTERISTICS OF GLOBALISATION

From an economic perspective, globalisation can be defined as the ever-increasing integration of the world's local, regional and national economies into a single international market. It is the increasing economic interdependence between countries. Globalisation is characterised by several interlinked trends.

INCREASE IN TRADE AS A PROPORTION OF GDP

Since the 1950s the rate of economic integration between world economies has accelerated. An ever-larger share of world GDP is exported to other countries. Both exports and imports as a percentage of GDP have increased for most economies. There has been a trend for the export share of world GDP to increase over time.

The rise in export share of world GDP is due to the acquisition of capital equipment, know-how, efficient transport, and cheap labor in developing countries. Rapid economic growth in emerging economies creates new markets for advanced goods, and services trade is also growing. Global supply chains, such as China's production of finished goods and assembly of intermediate components, are also contributing to this trend.

INCREASE IN IMPORTANCE OF TRANSNATIONAL COMPANIES (TNCS) AND FOREIGN DIRECT INVESTMENT

Transnational (or multinational) companies have grown in number and size. In some industries, such as car manufacturing or the oil industry, this is because only large transnational companies have the economies of scale and technological knowledge to make products that are both cheap and technologically advanced.

Foreign direct investment is the flow of money between countries where one firm buys or sets up a firm in another country. The opening up of global financial markets, with the removal of **capital controls** in many countries, has made foreign direct investment easier.

INCREASE IN MIGRATION

Increased migration is a characteristic of globalisation. Many migrants are forced to move from their homes because of war or natural disasters. However, many are economic migrants, moving because they think they can enjoy a better standard of living for themselves and for their families in a new country. In an increasing global economy, migration is likely to increase over time.

THE FACTORS CONTRIBUTING TO INCREASED GLOBALISATION OVER THE LAST 50 YEARS

Globalisation is caused by a complex mix of factors, none of which on their own can account for the process of globalisation. Some of the causes of globalisation can be categorised as follows.

TRADE LIBERALISATION

Trade in goods and services has grown, partly because of **trade liberalisation**.

INCREASED NUMBER AND SIZE OF TRADING BLOCS

A trading bloc is a group of countries that have signed an agreement to reduce or eliminate tariffs, quotas and other protectionist barriers between themselves. This agreement is called a regional trade agreement.

POLITICAL CHANGE

Over the past 50 years, significant political changes have occurred due to the breakdown of the Soviet system and the opening up of China. China's 1978 reforms led to a market-based economy, allowing foreign trade and investment. In 2001, China joined the World Trade Organization, impacting globalisation. China's cheap labor and large population have shifted manufacturing jobs and increased global consumption. The collapse of the Soviet system in 1989 and the dissolution of the USSR in 1991 further influenced globalisation, with Russia joining the WTO in 2012.

REDUCED COST OF TRANSPORT AND COMMUNICATION

Average transport costs (cost of transport per unit of output) have fallen significantly over the last 50 years. The use of larger planes and ships means firms have been able to gain from economies of scale. Technical efficiencies have also been gained through containerisation, which has made it cheaper to transport goods on freight ships, trains and lorries. Standardisation of containers made it easier for cargo to move between ports, as cranes became compatible

INCREASED SIGNIFICANCE OF TNCS

Transnational companies (TNCs) have significant product operations in at least two countries and account for 2% of the world's jobs. They own or are involved in supply chains that account for over 50% of world trade. TNCs grow due to globalisation, relocating production and sourcing raw materials, and selling into new markets. They can reduce costs, gain economies of scale, develop global brands, and avoid protectionist measures by locating production abroad.

FOREIGN DIRECT INVESTMENT BY TRANSNATIONAL COMPANIES

REASONS FOR FDI

There are a number of reasons for FDI by transnationals. Most TNCs will be driven by the opportunity to earn higher profits, gain higher market share and remain price competitive in very competitive business environments.

THE IMPACT OF FDI ON RECIPIENT COUNTRIES FDI

often creates a positive impact on the recipient country, particularly if it is **'greenfield' foreign direct investment,** rather than just a change of ownership through mergers and buy-outs of a company which already existed in the recipient country.

Greenfield FDI by transnationals will create jobs wherever they set up operations. This will set off a positive **multiplier effect** and generate economic growth in the recipient country. Transnational companies usually recognise that creating an international employment base leads to greater productivity. This should increase labour productivity and help to drive increases in real GDP **per capita**. In the case of greenfield FDI, the increase in productive capacity in the economy will also increase potential growth.

FDI is also likely to lead to the transfer of technology and skills to the local economy. For example, a US car component manufacturer may build a manufacturing plant in China. It will almost always import some machinery and equipment from the US. But it will combine that with locally produced investment capital, such as buildings.

SUBJECT VOCABULARY

capital controls intervention by governments to prevent capital flight

containerisation the use of containers, with standardised dimensions, in the transport of goods

foreign direct investment (FDI) flows of money between countries where one firm buys or sets up another firm in another country

globalisation from an economic perspective, the ever-increasing integration of the world's local, regional and national economies into a single international market

greenfield foreign direct investment when a firm in one country creates a firm in another country from scratch, or extends the production capacity of an existing firm

multiplier effect the increase in final income arising from any new injection of spending

per capita per individual in a population

protectionism government actions or policies that restrict international trade

regional trade agreement an agreement between at least two countries to reduce or eliminate tariffs, quotas and other protectionist barriers between themselves

trade liberalisation the move towards greater free trade through the removal of protectionist barriers to trade

trading bloc a group of countries that have signed an agreement to reduce or eliminate tariffs, quotas and other protectionist barriers

transnational/multinational company or **transnational/multinational corporation** a company with significant product operations in at least two countries

Chapter 22 – Effect of globalization

THE POSSIBLE BENEFITS OF GLOBALISATION INCREASED ECONOMIC GROWTH

Globalisation can increase both actual growth and potential growth for an economy. Research suggests there is a link between greater trade openness and higher income per capita.

Some economies will particularly benefit from globalisation, since their growth is driven by exports.

China has experienced rapid economic growth due to export-led growth, with exports accounting for 37.2% of GDP in 2006. Globalisation has also increased potential growth through the impact of trade on productivity. Competition between firms creates more efficient firms, leading to higher productivity and potential growth. Trade openness allows productive firms to expand, reallocating resources towards higher-productivity sectors. Competition promotes dynamic efficiency, encouraging firms to invest in innovation and new technology. Additionally, increasing migration can fill skills gaps and increase productivity. However, not all countries or regions will benefit, as some firms may be more productive or forced to close, generating negative impacts on the economy.

INCREASED TAX REVENUE

Globalisation boosts economic growth, leading to increased tax revenue. This includes income tax revenue, goods and services tax revenue, and corporate tax revenue. Imports and FDI inflows also generate tax revenue. However, tax revenue in developing countries is lower than in developed ones, ranging from 10-15%. To generate higher tax revenues, developing countries need to broaden their tax base and improve tax collection efficiency.

ECONOMIES OF SCALE

Globalisation creates a large international market for firms, allowing them to benefit from economies of scale. This allows them to increase production, reduce costs, and benefit both producers and consumers. Both internal and external sources of economies of scale can be used. As countries specialize in producing goods, firms within those countries may also benefit from external economies.

LOWER PRICES AND HIGHER CONSUMER SURPLUS

Globalisation can lead to lower prices and higher consumer surplus as production is switched from high-cost locations to low-cost ones. This is achieved through the use of lower-paid workers, often in developing countries. Lower tariffs on imported goods can also contribute to lower prices for consumers. Productivity gains by firms also help maintain global price competitiveness. Lower prices increase consumer surplus, benefiting lower-income households who spend more on tradeable goods. However, globalisation can also lead to higher prices due to increased world incomes and demand for individual products. Commodity prices initially increased due to increased demand from China, but have since collapsed due to slowed growth and increased supply.

MORE CHOICE

The availability of goods and services has considerably increased with globalisation so there is more consumer choice. The number of different products available in high streets, shopping centres and supermarkets is larger than it was 20 years ago. It is the same in the services market.

HIGHER LIVING STANDARDS

Globalisation promotes a rise in real GDP per capita, resulting in higher living standards. However, not all consumers benefit, such as US workers losing jobs due to production shifting to China. Developing countries have also benefited from inward FDI flows, shifting production from developed to developing countries, potentially improving living standards.

POSSIBLE COSTS OF GLOBALISATION

DISPLACED WORKERS

The transfer of much of manufacturing from western Europe and the USA to countries such as China has led to large-scale losses of jobs in the developed world. At the same time jobs have been created in the developing world.

EXPLOITATION OF WORKERS

Exploitation occurs when employers unfairly treat workers, especially unskilled labor. In advanced economies, low-skilled workers compete with those in developing countries, leading to higher wages and reduced negotiation power. However, advanced economies typically have employee protection laws and minimum wages to minimize exploitation. Globalization's increasing importance of transnational corporations and foreign direct investment can lead to poor working conditions in developing countries. Despite this, many workers in developing countries may not feel exploited, as working for a transnational raises their standard of living.

ENVIRONMENTAL IMPACT OF INCREASED TRADE

Rising world production inevitably has an impact on the environment. If world production of wooden furniture rises, there must be an increase in logging of trees. If world food production rises, this must have an impact on the amount of land in cultivation and farming practices. If every Chinese and Indian household is to own a fridge, there must be an increase in the production of iron ore and electricity.

LOSS OF TAX REVENUE

Firms which operate in several countries (i.e. transnationals) have the ability to engage in tax avoidance. **Tax avoidance**, although legal, suggests a firm is deliberately manipulating the tax system to pay less than a 'fair' amount. There are three main ways in which they do this.

• One is based on genuine production and **transfer pricing.** A firm produces good X in country A and then transports it to country B; here, it uses good X to produce good Y, which it then sells. Country A has high taxes on profits and country B has low taxes on profits.

• A second way is to set up an office in a low- tax country such as Ireland, Luxembourg or the Bahamas. Ownership of a key production element such as a patent, copyright or sales is assigned to that country and a significant proportion of costs is then assigned to that key production element which at best eliminates all profit made in other countries. The revenues are then taxed in Ireland, Luxembourg or another **tax haven** at virtually zero per cent. As a result the transnational avoids tax.

• A third way is to transfer production facilities to a low tax country. Ireland has attracted many firms, for example, because it has very low taxes on profits compared to other EU countries.

INCREASED INCOME INEQUALITY WITHIN COUNTRIES

Globalisation is shifting workers to different locations and places of work, causing a shift in wages for low-skilled workers in developed countries. This has led to a decrease in wages for low-skilled workers in developed countries, while high-skilled workers face increased demand in a global market. The impact on income inequality in developing countries is unclear, as income inequality is rising in some countries but falling in others. Globalisation will create new industries and job types, and demand for labor is likely to increase, especially if globalisation leads to export-led growth. However, wage differences between low-skilled and skilled labor could widen or narrow. Transnationals often employ skilled workers in low-wage countries, increasing income inequality.

THE INFLUENCE OF TNCS ON DOMESTIC ECONOMIC POLICY

Transnational companies are able to influence the decisions of governments across the world. This is partly because they have the skills and the money to lobby governments

NON-ECONOMIC IMPACT OF GLOBALISATION

Globalisation impacts not only economics but also politics, social, technological, and culture. It weakens native cultures, particularly the US, and weakens nation-states' sovereignty. This is due to international treaties and the strong forces of globalisation, making it difficult for nation-states to completely censor news, books, or films.

THE OVERALL IMPACT OF GLOBALISATION

Globalisation can lead to economic benefits such as rising incomes, better jobs, and lower prices, while also causing long-term consequences like industry loss and higher unemployment. For instance, the UK's textile and shipbuilding industries were destroyed by globalisation and competition from the Far East. In countries like China, the rapid growth of industries has negative environmental impacts and internal migration, affecting family ties.

Arguments for and against globalisation tend to be linked to a number of other economic debates, discussed elsewhere in this book.

• Does economic growth lead to an increase in economic welfare?

• Is economic growth unsustainable from an environmental perspective?

• Does protectionism rather than free trade promote economic growth?

• Do transnational companies have more power over economies than most nation states and do they act purely to gain profit for their shareholders?

• To what extent are developing countries lifting themselves out of poverty? Is there any evidence to suggest that developing countries are catching up with developed countries?

• Is the rich, developed world exploiting the poor, developing world?

• Are organisations such as the WTO or the IMF, which support or promote trade liberalisation, controlled by the rich countries of the world and do they act against the interests of poorer countries?

SUBJECT VOCABULARY

economies of scale a fall in the long run average costs of production as output rises

redistribution when income and wealth is taken by governments from some individuals and given to others

sweatshop a small business, factory etc. where people work hard in bad conditions for very little money

tax avoidance when an individual or firm deliberately manipulates the tax system to pay less than the 'fair' amount

tax base the income and wealth which a government can tax based on their tax laws

tax haven a place where people go to live, or firms locate, to avoid paying high taxes in their own country

transfer pricing an accounting technique used by transnational companies to reduce taxes on profits by selling goods at a low price internally from a high-tax country to another part of the company in a low-tax country