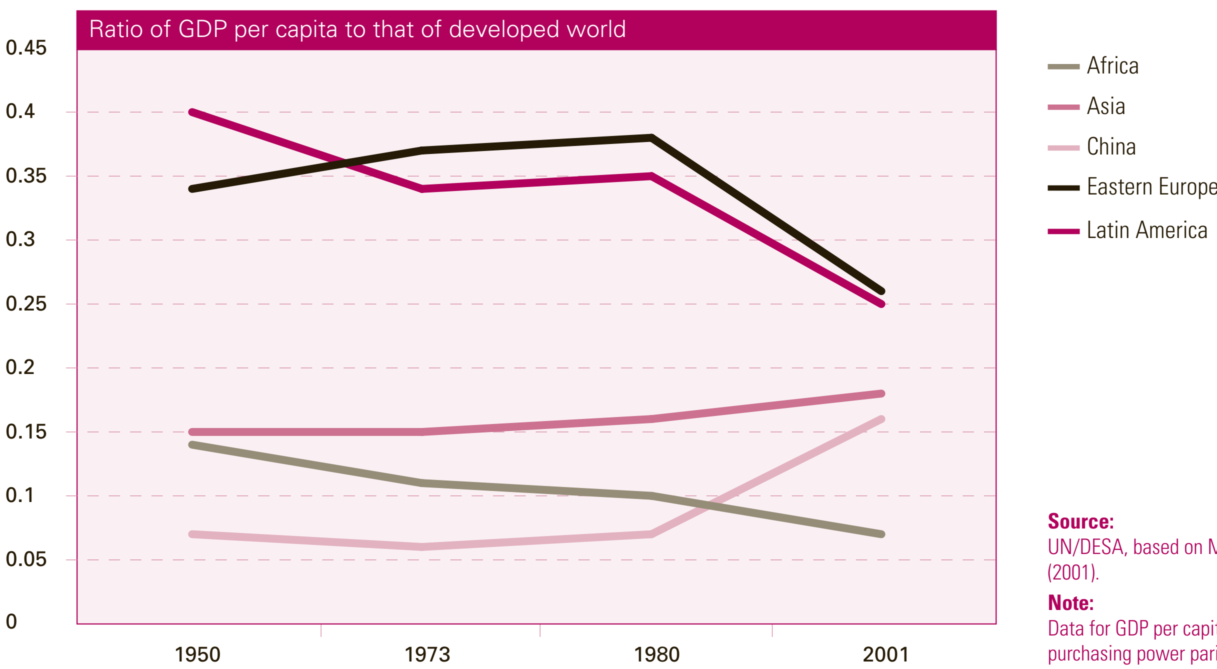
Overview

By many measures, global income inequality is high and rising

By many measures, global income inequality is high and rising. In 1950, the average Ethiopian had an income 16 times less than that of someone living in Europe or the United States of America. Half a century later, Ethiopians have become 35 times poorer. Most of the world's poorest nations are falling behind in more or less similar degrees. The main reason is that in the industrialized world the income level over the last five decades has grown steadily, while it has failed to do so in many developing countries, especially over the past quarter of a century. Not more than a few developing countries have been growing at sustained rates in recent decades, but these include, most notably, the world's two most populous countries, China and India. Considering that these two countries alone account for more than one third of world population, inequality across the globe is beginning to decline. When these countries are left out, however, international income inequality is seen as having continued to rise strongly from already high levels (see figure O.1).

Figure O.1.
GDP per capita in selected developing regions and China relative to that in the developed world, 1950-2001



Source: UN/DESA, based on Maddison (2001).
Note: Data for GDP per capita are in purchasing power parity dollars.

These developments are at odds with the conventional economic wisdom regarding how income differentials among countries change over time in a more integrated world economy. During the 1980s and 1990s, there had been a belief that giving more space to the global market would lead to a closing of the income gap between poor and rich countries. In reality, income convergence took place only for a small number of countries, but this did not happen in the case of many others, despite the fact that countries across the globe had opened up their trade and financial systems to the global market.

Inequality matters

The World Economic and Social Survey 2006 focuses on the causes and implications of the income divergence *between* countries. High income inequality also prevails *within* many countries. This is a problem not only because it signals injustice, but also, and in developing countries particularly, because unequal opportunities make it much more difficult as economic potential stays unutilized to achieve the Millennium Development Goals. We are concerned here, however, with the rising inequality *between* countries. About 70 per cent of global income inequality is explained by differences in incomes between countries. While this does not make the disparities within countries any less important, it is striking that the probability of having a better living standard to a very large extent appears to be conditioned by where one happens to live.

World markets are far from equitable and there are several conditions that do not favour a narrowing of the income divergence between countries. Richer countries have better "endowments" which give them preferential access to capital markets and make them less vulnerable to shifts in global commodity markets. Global investors generally prefer countries with greater wealth and better-developed human capital, infrastructure and institutions, which ensure lower investment risk. Poorer countries have less diversified economies and export structures, making them much more vulnerable to shifts in commodity prices and to shocks in international financial markets. Developing countries also have less of a voice in the negotiation processes setting the rules governing global markets. The Monterrey Consensus of the International Conference on Financing for Development (United Nations, 2002a) recognized this weakness and gave a clear mandate to the international community to improve the participation of developing countries in global decision-making. However, there has been very limited progress in this area.

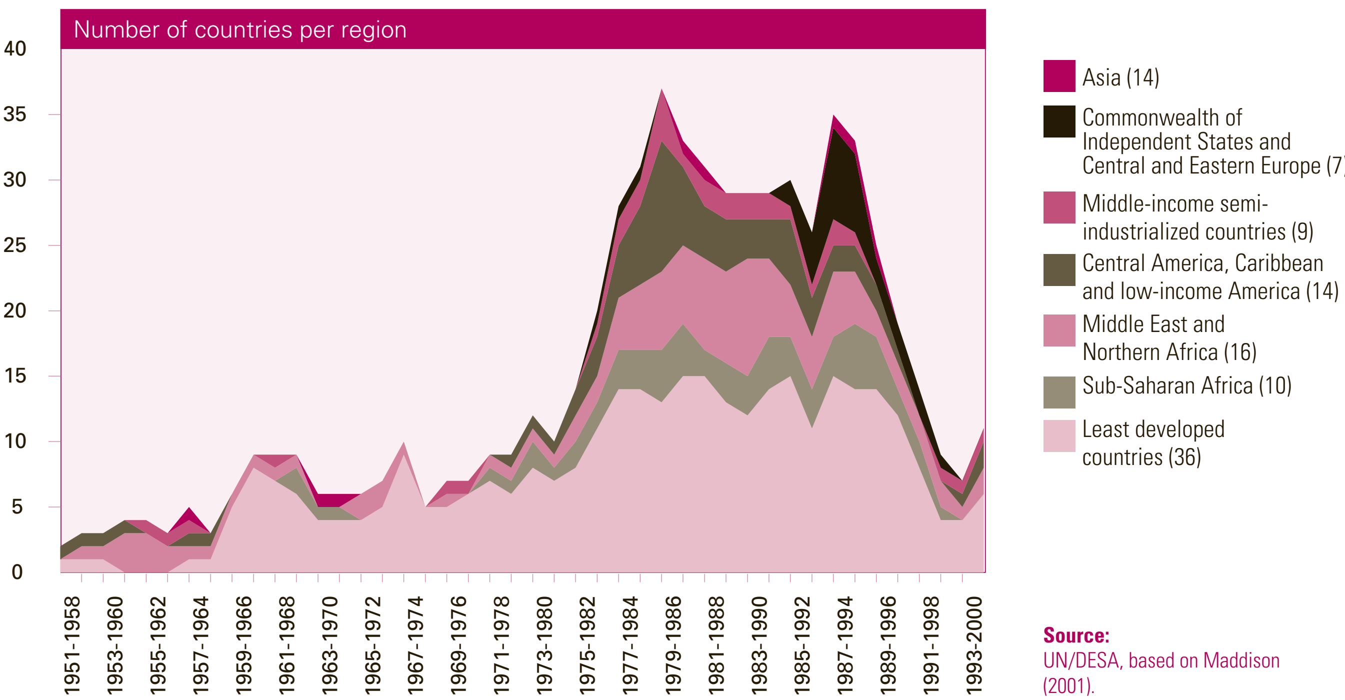
Widening global disparities in turn may be harmful to growth itself. Reduced access to a stable source of international finance and a weaker bargaining position in international trade will leave some of the economic potential of poor countries underutilized and this should be considered a welfare loss for the world economy at large. Lower growth further obstructs efforts to eradicate poverty. In some cases, the lack of poverty reduction and high within-country inequality also have been shown to foment conflict and social instability.

Ignoring the slow development of a large number of countries means ignoring one of the main sources of growing world income inequality. To redress this will require both domestic and international policy efforts.

Diverging patterns of economic growth

Rising inequality between countries is the result of differences in economic performance over several decades. Broadly speaking, the income gap between the industrialized economies and developing countries was already very high in 1960 and has continued to widen since then. At the same time, however, the growth experiences among the developing countries have differed greatly. Widening income disparities among developing countries became prominent after 1980 as the result in part of a limited number of success stories of sustained economic growth, most of them in East Asia. In other parts of the world, a much larger number of countries have suffered growth collapses with long-lasting impacts on living conditions. During the past 25 years, the number of cases of growth collapses has increased, whereas the frequency of cases of successful growth has diminished. In the 1960s and 1970s, nearly 50 out of a sample of 106 developing countries had experienced one or more prolonged episodes of high and sustained per capita income growth of more than 2 per cent per year (see figure O.2). Since 1980, however, there are only 20 developing countries that have enjoyed periods of sustained growth. In contrast, no less than 40 developing countries suffered growth collapses, that is to say, periods of five years or longer during which there had been no growth or a decline in per capita income. Such growth failures have been most frequent among the least developed countries and countries in sub-Saharan Africa. In the preceding decades, growth collapses had rarely occurred and had affected fewer than 10 countries.

Figure O.2.
Growth collapses among developing countries, 1951-2000



Source: UN/DESA, based on Maddison (2001).

Developing countries have, of course, done well very recently. Indeed, current trends indicate that the period 2004-2006 will show fairly widespread growth in developing countries, a pattern not seen since the late 1960s and early 1970s. During these three years, per capita income of developing countries will grow on average at a rate of more than 4 per cent per year and the least developed countries will perform even better. Whether this recent performance signals a longer-term trend is still to be determined. Some key factors behind it have been a combination of high commodity prices, low interest rates and increasing official development assistance (ODA) and debt relief to the poorest countries. As these favourable conditions will not be permanent, the continuation of strong growth will depend critically on the ability of developing countries to use the dividends of the current positive conjuncture for investments in the interest of long-term economic development.

Economists have no conclusive answers regarding the precise causes of growth successes and failures. Recent studies have been rediscovering the complexities of economic growth.

A newly emerging consensus is that the search for answers should not merely focus on economic factors, but also take into account the historical and institutional setting of each country. The analysis should focus on a diagnosis of the binding constraints on growth such as limitations in mobilizing sufficient domestic or foreign finance, low levels of human capital and technological capabilities, weaknesses in governance structures and the poor functioning of institutions that regulate markets or provide public goods and social services. The importance and relevance of these constraints tend to vary from country to country. This report attempts to contribute its own findings during what is in fact a journey of discovery, in particular by looking at how the workings of global markets affect the sources of growth and influence the space in developing countries for the domestic policymaking undertaken to overcome such constraints. Success in development depends both on efforts undertaken at the country level to create dynamic sources of growth and on an enabling international environment.

Productivity growth and structural change

Productivity growth in developed countries relies mainly on technological innovation. For developing countries, however, growth and development are much less about pushing the technology frontier and much more about changing the structure of production so as to direct it towards activities with higher levels of productivity. This kind of structural change can be achieved largely by adopting and adapting existing technologies, substituting imports and entering into world markets for manufacturing goods and services, and through rapid accumulation of physical and human capital. Only very few developing countries have been able to undertake original research and development.

The industrial sector typically contributes more dynamically to overall output growth because of its higher productivity growth, which results from increasing returns to scale and gains from technological progress and learning-by-doing. Its greater dynamism is also derived from its capacity to forge greater vertical integration of different sectors of the economy by processing raw materials and semi-industrial inputs. Modern service sectors are also a source of productivity gain and are essential to the achievement of industrialization. As international trade for services grows, they also offer a new opportunity for export development.

More broadly, dynamic structural change involves more than just growth of industry and modern services. It entails essentially the ability to constantly generate new dynamic activities. It also involves strengthening economic linkages *within* the economy—in other words, integrating the *domestic* economy. The degree of integration of the domestic economy influences whether a country is able to gain from international trade and investment. It also affects the capacity to improve productivity in all major sectors of the economy.

Patterns of structural change over the past four decades indicate that such dynamic transformations have clearly characterized the fast-growing East and South Asian economies. Economies characterized by relatively little structural change have lagged behind, particularly in Africa. Sluggish long-term growth in the middle-income countries of Latin America and the Caribbean as well as countries in Central and Eastern Europe, the Middle East and the former Union of Soviet Socialist Republics has in fact been associated with a process of *deindustrialization*. In those countries, growth was largely concentrated in low-productivity services, with agriculture and industry remaining nearly stagnant. Fast growth in East and South Asia, in contrast, has been associated with a rapid decline in the importance of agriculture and strong expansions of both the industrial and service sectors.

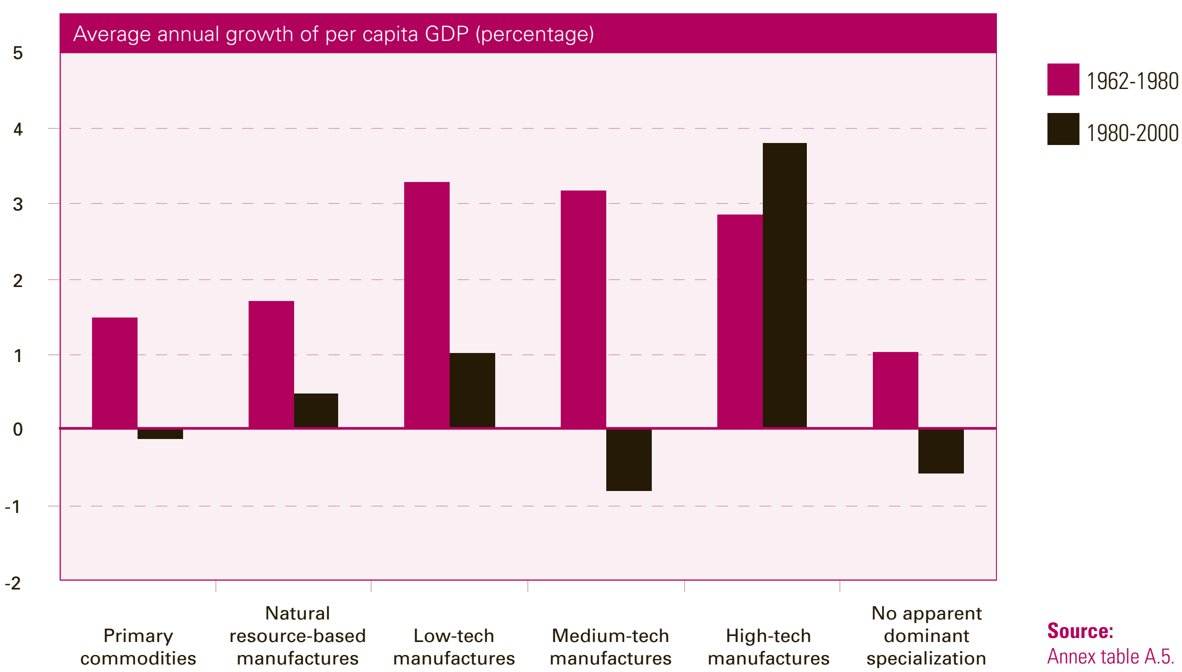
These fast-growing economies have also shown sustained increases in labour productivity, with labour moving from low- to high-productivity sectors, including modern service sectors. In the regions with low-growth performance, the employment shift to the service sector has been even stronger. However, in contrast with Asia, the service sectors in sub-Saharan Africa, Latin America and the former Soviet Union have shown declining productivity as many workers have sought employment in informal service activities owing to the lack of job creation in other parts of the economy.

International trade, foreign direct investment and inequality

It matters what—not only how much—you export

Increased integration into the world economy seems to have exacerbated the divergence in growth performance among countries. Trade can help stimulate growth, but in the first instance it is a matter not of *how much* countries export, but rather of *what* they export. Faster overall economic growth driven by trade is associated with more dynamic export structures (see figure O.3). These are understood as encompassing the export mix that allows countries to not only participate in world markets for products with greater growth potential (most often high-tech products with a high income elasticity of demand) but also help strengthen productive links with the rest of the domestic economy and generate increased value added for a wider range of

Figure O.3.
Trade specialization and economic growth of countries classified by main type of export commodities, 1962-2000



Source: Annex table A.5.

services and products. The East Asian countries managed to diversify their economies in this manner, as had already been evident from the pattern of structural change. The slower-growing developing countries relied on export activities with less value added that were rooted in a less integrated domestic economy. Many of these countries remain heavily dependent on exports of primary commodities and have lost market shares in world trade. They also have suffered from larger adverse trade shocks. Primary commodity prices have been more volatile than those of other export products and the terms of trade for non-oil commodity exports declined by almost 40 per cent between 1980 and 2003. The recent recovery in commodity prices has only partially offset this decline. By the end of 2005, average non-fuel commodity prices were still below 1980 levels in real terms.

Diversifying into high-technology exports may not be an immediately feasible option for many developing countries. Low-income countries typically lack adequate basic manufacturing capacity, infrastructure and human capital, as well as international trading capacity to develop such dynamic export activities. As these countries do have some capacity to compete in world markets for primary goods, they should lay out industrial strategies to diversify exports so as to encompass processing natural resource-based products and light manufactures.

Foreign direct investment can foster growth, but only if it supports domestic linkages

The impact of foreign direct investment (FDI) on economic growth is directly dependent on the role it can play in strengthening *domestic* linkages in the economy. Since the 1980s, FDI has grown at a faster pace than have both world output and trade. This trend has been fostered by, among other things, the development of international production networks in manufacturing industries and modern services, the lifting of restrictions on capital flows and the privatization processes in developing countries. Developing countries have witnessed a 10-fold increase in the average annual inflows of FDI. Nonetheless, most (over two thirds) of FDI remains concentrated in developed countries. FDI to developing countries is also heavily concentrated, with well over 80 per cent of the flows moving to only a dozen (mostly middle-income) countries, including China and India.

FDI brings finance and technology and thus could contribute significantly to long-term growth in developing countries. Clearly, however, FDI is mostly attracted to countries with higher incomes and better-developed markets, infrastructure and human capital. In this sense, FDI appears to have been a force for growth divergence. Also, countries with substantial increases in FDI have not always witnessed a strengthening of their economic growth. All major Latin American countries, and also some larger African countries, had witnessed higher shares of inward FDI relative to their gross domestic product (GDP) between the 1980s and the 1990s; yet, overall investment rates stagnated or declined. Moreover, FDI in Africa has been concentrated in mining activities, with few linkages and employment effects that benefit the wider economy.

This report concludes that in order for countries to profit from FDI, their domestic firms and institutions need to have the requisite absorptive capacity and technological capability. Countries that made significant investments in building domestic infrastructure, human capital and entrepreneurial capabilities (for example, Singapore and Ireland) were also the most successful in leveraging inward FDI. Conversely, there seems limited scope for long-term benefits from FDI when it is attracted in response to major tax incentives, or as a result of trade policy distortions (such as textile and clothing quotas), without a simultaneous build-up of local capabilities and without the creation of linkages between foreign affiliates and local firms.

Trade and investment policies for growth

Trade liberalization has been the main policy trend in recent decades. In most parts of the world, this has led to an expansion of export volumes, but not necessarily to higher economic growth. Countries able to diversify and change the structure of production to encompass activities of higher productivity have seen more visible growth gains. Fostering greater economic and export diversification is a major challenge. It will require both active domestic policies and a more enabling trading environment for developing countries.

First, there is a case to be made for the adoption by developing-country Governments of active production sector development strategies. Most developing and developed countries that witnessed sustained successful economic growth had used active industrial policies to support the economic diversification and technological upgrading of their economies. Among developing countries, export-led growth strategies of the success cases involved varying combinations of supportive macroeconomic policies (see below), selective infant industry protection, export subsidies, directed credit schemes, local content rules and large investments in human capital, as well as strategic alliances with multinational companies. Support measures were often clearly tied to specific export performance criteria. The space for conducting this type of active production sector development policies has narrowed in the context of the multilateral trade agreements, but has not disappeared completely. Developing countries, particularly the least developed countries, have been given special and differential treatment as defined under the General Agreement on Tariffs and Trade (GATT) and the Uruguay Round of multilateral trade negotiations. In practice, however, developing countries, aside from the poorest ones, have had to apply the same rules as the developed countries but were allowed longer implementation periods and higher levels of protection.

Second, developing countries will need a better multilateral trading environment. Better trading opportunities for developing countries should involve improved market access for their exports of both agricultural and light manufactures, reduced domestic support for agricultural production in developed-country markets and, particularly, the elimination of trade-distorting domestic and export subsidies for agricultural goods. Better trading opportunities also mean better opportunities to participate in world markets for services, including those that require mobility of low-skilled labour. For least developed countries, duty-free and quota-free access to markets in industrialized countries is essential. All developing countries also need assistance in finding ways to address the costs of adjustment to a freer trading order, particularly those countries that lose trade preferences in the process.

Third, developing countries also need more space for adopting policies aimed at building the supply capacity that is needed to succeed in global markets and that encourages a dynamic structural change in their economies. For the poorest countries, the required policy space is somewhat less constrained than for other developing countries. For all developing countries, more attention than in the past should be given to rules that facilitate diversification of production into dynamic raw materials for export markets and, more importantly, into manufactures and services. More attention also needs to be paid to policies that facilitate the links between those sectors and other domestic activities and, more broadly, encourage *domestic* market integration. This may require special measures in support of infant *export* industries. Additional space is also needed to give agreements on intellectual property rights a more developmental orientation. These issues should thus be a subject of greater attention in the context of the definition of special and differential treatment for developing countries in multilateral trade agreements. More broadly, as underscored in the São Paulo Consensus adopted by the United Nations Conference on

Trade and Development (UNCTAD) at its eleventh session in June 2004 (document TD/412, Part II), it is important to find an appropriate balance between national policy space and international discipline and commitments.

Volatile private capital flows and pro-cyclical macroeconomic policies have harmed growth

Volatile capital flows to developing countries

There is no evidence that private non-FDI financial flows have consistently led to increased investment and growth in developing countries over the past 40 years. They certainly have not been a force in reducing international income inequality. Since the 1970s, developing countries, but mostly middle-income countries, have gained greater access to short- and long-term private financing, but these flows have largely marginalized the poorest countries. At the same time, commercial bank lending and other portfolio investments have proved to be highly pro-cyclical for developing countries. Both the availability and the cost of external financing ease during periods of economic expansion, and tighten and become more expensive during economic downswings. In this way, private external financing has contributed to increased economic volatility and during the 1980s and 1990s, the related surges and sudden stops in private capital flows were a cause of major financial crises. Economic volatility creates greater uncertainty with adverse effects on long-term investment and growth. The costs of the currency and banking crises themselves were massive and, according to some estimates, these crises have lowered the income of developing countries by 25 per cent or more. The challenge for developing countries is to reduce their reliance on volatile short-term flows and create conditions that ensure that long-term private financing is channelled towards productive investment.

Both macroeconomic stability and policy flexibility are important for growth

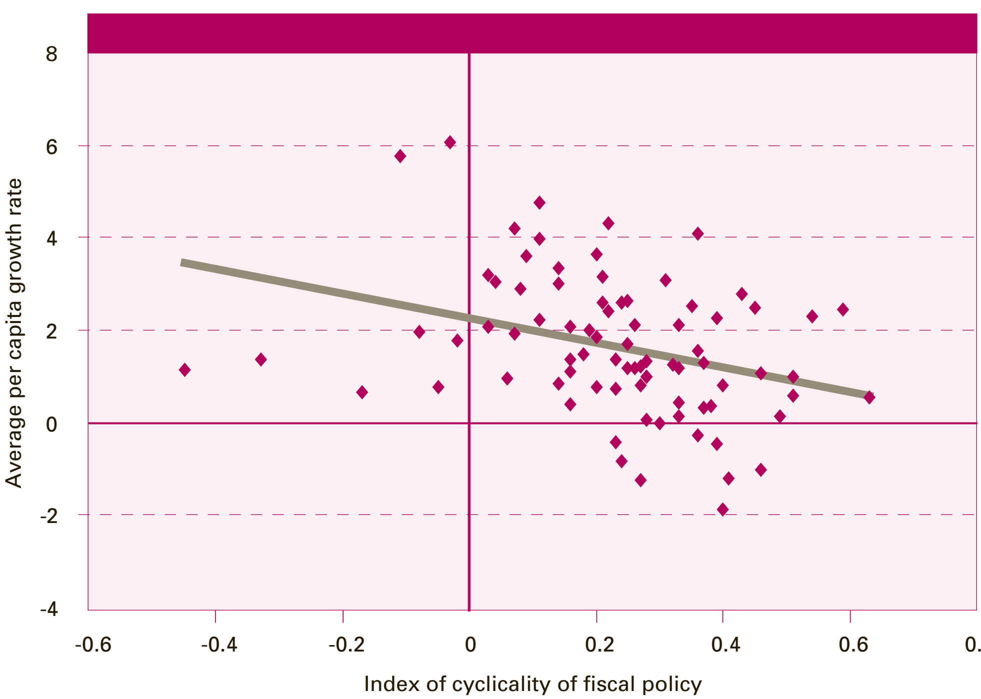
Macroeconomic stability strongly influences the long-term growth performance of the economy. Macroeconomic stability should be understood in broader terms as entailing more than just preserving price stability and sustainable fiscal balances. It is also about avoiding large swings in economic activity and employment and, further, about maintaining sustainable external accounts and avoiding exchange-rate overvaluation. The frequency of financial crises in developing countries indicates that macroeconomic stability is, in addition, about maintaining well-regulated domestic financial sectors, sound balance sheets within the banking system and sound external debt structures.

A majority of developing countries had enjoyed robust growth and a relatively stable macroeconomic environment in the 1960s. In the decades thereafter, the fast-growing East Asian economies managed to achieve much greater macroeconomic stability than the much slower growing countries in Latin America and Africa. Macroeconomic stability and growth mutually reinforce each other. Strong and sustainable growth makes it easier to achieve greater macroeconomic stability by, among other things, enhancing the sustainability of domestic and foreign public debt. Conversely, greater stability, in its broad sense, reduces investment uncertainty and hence is supportive of higher long-term growth.

Stabilization policies as implemented in many developing countries since the 1980s have mostly emphasized the objectives of lowering inflation and restoring fiscal balances. While moderating inflation and exercising fiscal prudence as sensible macroeconomic policy objectives are not subject to dispute, there are concerns that, in practice, countries may have emphasized these objectives at the cost of considering other dimensions of macroeconomic stability. In particular, price stability often has been achieved at the cost of producing exchange-rate appreciation and unsustainable external debt burdens. Moreover, macroeconomic policies in much of the developing world have been highly pro-cyclical over the past two decades. This has been particularly costly during periods of economic slowdown, when such policy stances have led to lower economic growth and employment.

The analysis in this report shows that the fiscal policy stance in African and Latin American countries has been highly pro-cyclical and was often induced by the pro-cyclical effects of volatile capital flows. In East Asia, fiscal policies have been either neutral with respect to the business cycle or counter-cyclical. There is a strong negative correlation between pro-cyclical fiscal behaviour and long-term growth when measured for a large sample of developing countries (see figure O.4). Creating space for counter-cyclical macroeconomic adjustment policies thus appears to be beneficial for growth and in so being, can contribute to income convergence. This is all the more important for developing countries, compared with developed ones. Macroeconomic volatility tends to be much higher at lower levels of development, particularly because of the greater vulnerability of developing countries to external shocks.

Figure O.4.
The negative influence of pro-cyclical fiscal policy on long-term growth



Source:
UN/DESA, based on data by Kaminsky, Reinhart and Végh (2004); and World Bank, World Development Indicators 2005 database.

Note:
The index is constructed as a weighted average of indicators of fiscal policy cyclicality, which include public expenditure, a proxy for changes in tax rates and changes in expenditures over the business cycle in developing countries. Positive figures denote higher pro-cyclicality; and negative numbers, the level of counter-cyclicality. Further details may be found in Kaminsky, Reinhart and Végh (2004).

More space is needed for counter-cyclical macroeconomic policies

For many developing-country Governments, the space for conducting counter-cyclical macroeconomic policies is limited, as the available fiscal and foreign exchange resources tend to be small relative to the size of the external shocks they face. International action mitigating the impact of private capital flow volatility (see below) can further help to enhance the necessary policy space. However, also at the country level, Governments can take measures to enhance the scope for counter-cyclical policies by improving the institutional framework for macroeconomic policymaking.

First, the more appropriate institutional setting for fiscal policy should strike a balance between fiscal prudence and fiscal flexibility in a way that ensures both policy credibility and fiscal sustainability. Setting fiscal targets that are independent of the short-term fluctuations in economic growth (so-called *structural* budget rules) can be effective in forcing a counter-cyclical policy stance. Some developing countries, such as Chile, have been able to manage such fiscal rules successfully. Further, fiscal stabilization funds could help smooth out over time the revenues from unstable tax sources, such as those based on primary export production. The experience with the application of such funds in various parts of the world has varied. They are by no means a panacea and careful management of such funds is required. Nonetheless, fiscal stabilization funds can constitute an effective instrument for resolving issues of inter-temporal trade-offs in fiscal spending by protecting growth-enhancing long-term public investment in infrastructure and human development also during periods of lower tax revenue ushered in by external shocks and economic downturns.

Second, a certain degree of discretionary power should be retained. Since the 1980s, Governments of many developing countries have moved from discretionary macroeconomic policy arrangements to rule-based ones. This shift was founded on the belief that the latter would avoid policy-generated macroeconomic instability. About 20 economies, for instance, adopted inflation-targeting as the framework for monetary policy. Under this monetary regime, an independent central bank commits itself to price stability by publicly announcing the level of inflation it will permit. There are a number of advantages to this kind of policy arrangement, including its potential to enhance central bank policy transparency and credibility. At the same time, however, the narrow focus of monetary policy on a strict inflation target biases macroeconomic stabilization against employment and growth objectives. Rule-based policies may function well for some time and when the economy is not suffering from major shocks. However, as the structure of the economy changes over time, so will vulnerability to external shocks. For instance, financial shocks may become more important than terms-of-trade shocks. In such a changing context, predetermined policy rules likely become less relevant or turn out to be too rigid. Moreover, as the risks and uncertainties facing an economy never present themselves in exactly the same way or with the same degree of intensity, a certain amount of space for discretionary policies is always needed in order for adjustments to be made that will minimize macroeconomic losses.

Third, macroeconomic policies should be well integrated with other areas of economic policymaking. A competitive real exchange rate seems to be critical in this regard. In the fast-growing East Asian economies, for example, macroeconomic policies were part of a broader development strategy, contributing directly to long-run growth. Fiscal policies in these economies have given priority to development spending, including investment in education, health and infrastructure, as well as subsidies and credit guarantees for export industries. Monetary policy was coordinated with financial sector and industrial policies, including directed and subsidized credit schemes and managed interest rates, to directly influence investment and saving, whereas competitive exchange rates were considered essential for encouraging exports and export diversification. In contrast, macroeconomic policies in many Latin American and African countries since the 1980s have been focused on much more narrowly defined short-term stabilization objectives and many times this has resulted in exchange-rate overvaluation.

International policies to dampen financial volatility

A major challenge for the multilateral financial institutions is to help developing countries to mitigate the damaging effects of volatile capital flows and provide counter-cyclical financing mechanisms to compensate for the inherent pro-cyclical movement of private capital flows. A number of options are available to dampen the pro-cyclicality of capital flows and thereby help to create a better environment for sustainable growth.

A first set of measures would include the adoption of financial instruments that reduce currency mismatches and link debt-service obligations to developing countries' capacity to pay (for instance, through GDP- or commodity-linked bonds). These could be accompanied by public loan guarantee mechanisms with counter-cyclical features issued by the multilateral development banks and export credit agencies. A third approach would involve support to developing-country Governments in strengthening regulatory frameworks that provide disincentives to short-term capital inflow volatility, and sound domestic financial private and public sector structures.

In addition, multilateral surveillance—primarily by the International Monetary Fund (IMF)—should remain at the centre of crisis prevention efforts. Enhanced provision of emergency financing at the international level in response to external shocks is considered essential to easing unnecessary burdens of adjustment and the costs of large reserve balances. For both middle-income and low-income countries, appropriate facilities should include a liquidity provision to cover fluctuations in export earnings, particularly those caused by unstable commodity prices and natural disasters. Access to official international liquidity during capital-account crises should be facilitated and made commensurate with the potentially large needs of countries that might surpass normal lending limits based on IMF quotas of members.

Investments in infrastructure and human capital are necessary for growth

Part of the observed growth divergence is attributable to gaps in public investment in, and spending on, infrastructure and human development in these countries.

The need for improved infrastructure

An adequate level of infrastructure is a necessary condition for the productivity of firms. Just imagine an economy without telephones, electricity or a road network. By its very nature, infrastructure is characterized by indivisibilities and countries will need to build up a threshold or minimum level of infrastructure (say, a minimum network of roads) to make a difference for economy-wide productivity growth. To reach that threshold, countries will need to sustain substantial public investment levels over prolonged periods of time. The failure to do so explains partly why Latin America and sub-Saharan Africa have fallen behind the East Asian countries that have sustained infrastructural investment. East Asian economies invested more in the quality and coverage of physical infrastructure. In sharp contrast, Latin American countries have witnessed a decline in infrastructural investment since the 1980s as a result of increased fiscal austerity. This has led to significant differences in the quality and availability of infrastructure. Since the 1960s, the road density in Latin America and sub-Saharan Africa has barely increased, while it has tripled in East Asia. Also, the availability of telephone lines in East Asia is twice as great as that in Latin America and 10 times greater than in sub-Saharan Africa.

The empirical evidence indicates that lagging infrastructural development could account for as much as one third of the widening income differentials between East Asian and Latin American countries during the 1980s and 1990s. The evidence shows further that there are important complementarities between public and private investment. Where Governments cut public investment in infrastructure or privatized infrastructural services, private investors failed to fill the gap. This outcome for a significant number of countries in Latin America and Africa is at odds with the initial expectations for such privatization programmes.

Human development is a necessary but not a sufficient condition for growth

Some empirical studies suggest that developing countries could catch up with the developed world if only they attained increased levels of human development. The links between growth and human development are complex, however. There are large disparities in indicators of human well-being, such as life expectancy and educational attainment. However, the world has seen more convergence among countries in terms of improvements in health and education outcomes than in terms of improvements in per capita incomes. The evidence in this report indicates that countries with a successful economic growth performance all had relatively high levels of human development at the beginning of their sustained growth process and showed substantial improvements in education and health as average incomes improved. Conversely, however, not all countries with relatively higher levels of human development managed to achieve high long-term economic growth rates.

Human development is, of course, an objective in its own right, which has been enshrined in the global agenda by United Nations conferences and summits. However, it seems that it is a necessary but not a sufficient condition for sustained economic growth. Lifting other constraints on economic growth and structural change will be necessary to create opportunities for a better-educated population. The dynamic creation of decent and productive employment is the crucial link in this regard.

Creating fiscal space for long-term investment in infrastructure and human development

Improvements in human development and infrastructural quality require adequate and sustained levels of public spending. Infrastructure development requires large-scale investments, which take time to mature. Improvements in education and health also entail longer-term efforts and require the permanent development and financing of social services. Good infrastructure, education and health can provide important social gains and this justifies the Government's central role in making sure that society invests in them sufficiently. Counter-cyclical fiscal policies, as discussed above, can help smooth the way towards maintaining adequate levels of current government spending and public investment and help ensure that spending on education, health and infrastructure is not unduly curtailed during economic downswings.

Countries with significant gaps in infrastructure and human development will have to substantially increase the fiscal space for expenditures in these areas. In many countries, much additional space can be gained by improving the efficiency in public spending on education and health through better targeting to priority areas within the social sectors and by improving the cost-effectiveness of public programmes. In infrastructure, improved financing schemes and combating corruption in the contracting of infrastructural works could help reduce costs. Yet, even with such gains in efficiency in public spending, resources may not be sufficient. Strengthening the tax base will be essential, particularly in countries with low government revenues. For the poorest countries, it is clear that substantial additional resources will be required for the necessary investments. More development aid will be required and will need to be allocated in support of investments in infrastructure and human development.

Increasing aid and its effectiveness

In 1961, when the General Assembly proclaimed the First United Nations Development Decade, it had been understood that an intensified effort to mobilize internal and external resources would be necessary if designated growth targets were to be met. It was also understood at the time that most of these resources would have to be allocated to infrastructure and human capital so as to overcome development bottlenecks. Increased aid flows were seen to be critical to overcoming such growth constraints and providing developing countries with a "big push". The target of 0.7 per cent of gross national income (GNI) of the developed countries for ODA emerged in this context. In the decades that followed, this target for aid transfers was not met by many and aid commitments of the member States of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) fell to a third of that target. In 2002, at the International Conference on Financing for Development held in Monterrey, Mexico, the international community reiterated the need for concrete efforts by the donor countries towards achieving the target of 0.7 per cent of GNI for ODA and included the Millennium Development Goals as tangible criteria against which to assess ODA effectiveness. Aid moved back to centre stage in the development debate and renewed proposals for big pushes—as in the early 1960s—emerged. Aid also regained its upward trend, now matched by debt relief for the poorest countries.

The effectiveness of international development assistance has become the subject of much dispute. According to some views, aid has not supported economic growth and investment and has done little to reduce poverty. This report, in contrast, contends that the weight of the evidence supports the view that aid has been positive for long-term development. Accordingly, ODA has partly countered the tendencies leading to the income divergence witnessed during the past 40 years. However, since the magnitude of aid transfers has remained limited, the impact of ODA on reducing international income disparities has been very weak at best.

The above provides some support for the revived idea of a big push for developing countries fuelled by aid. In this regard, the Millennium Development Goals could be viewed as a clear set of targets that require substantial investment to gear infrastructure and social services up to minimum threshold levels. Well-targeted programmes supported by aid could put the poorest nations on a path of faster growth. Such an approach assumes not only that enough is known on how to channel such resources efficiently in specific country contexts, but also that the Governments in the recipient countries have the administrative capacity to manage the resource flows in such a way as to ensure that cumulative income and productivity gains are generated. Conditions for improvements in the governance structure—particularly in such areas as transparency in budgetary processes, building a quality civil service and improving social service delivery—thus have to be part of the assessment of additional needs for development assistance. What really works at the local level, however, varies from country to country and hence adding externally defined governance conditionalities to aid and lending flows, which has been a recent practice of donor agencies, may not produce the desired outcomes in terms of better-quality public services.

Institutions and good governance

It is now widely recognized that institutions and governance structures matter for economic growth and thus for explaining widening global income disparity. It is difficult, however, to pin down which "quality" institutions and governance structures should be pursued in order to support sustained growth processes, as has been made increasingly clear by the extensive examination of their importance in recent years. Such quality appears to be inherently country- and context-specific. For policymakers, it is of relevance to know whether new economic opportunities can be unlocked in a significant manner even when making more modest and focused changes in the existing institutions and governance structures.

Looking at economic history and institutional change, it appears that even a build-up towards better institutional frameworks in very specific areas can lift constraints on growth. China's reform of rural institutions in the late 1970s had sowed the seeds of its current economic success. In 1978, China introduced the household responsibility system, under which households were provided with use rights to collectively owned land under long-term leases. In exchange, farmers were obliged to supply a pre-fixed share of output to the collectives' production quotas, but could sell the remaining output on the free market or to the Government at negotiated prices. Viet Nam also introduced a land reform programme with a limited transfer of property rights to tenants as a means to ease the constraint on agricultural productivity. The Republic of Korea and Taiwan Province of China, in contrast, enacted a full transfer of landownership to farmers shortly after the Second World War to achieve the same objective. In all cases, the ensuing and significant agricultural output growth formed the basis for industrial development.

Successes have gone beyond reforms of rural and agricultural institutions. Several countries, such as Mauritius and those in East Asia, integrated themselves successfully into the global trading and financial systems by gradually establishing different public-private institutions to diversify the productive structure, and new regulatory frameworks for the financial sector, while at the same time introducing compensatory measures to minimize the social and economic costs associated with reforms.

These cases suggest three important conclusions. First, several forms of governance restructuring can be effective in lifting binding constraints on economic growth. Success in the cases mentioned was determined largely by the fact that the institutional reforms had been properly tailored to the prevailing socio-economic systems in each country. Second, the relatively limited reforms in China and Viet Nam suggest that accelerated economic growth does not require immediate large-scale and comprehensive institutional reforms. Fairly minor institutional changes can have profound results if there is a sense that such changes are sustained and if they are perceived to be initiating a further process of credible reform. Third, institutional reforms entail much more than just *creating* markets (and thus granting property rights). They are also about creating the institutional and regulatory framework that markets need in order to function properly, about providing public goods and about guaranteeing the fairness of the rules (ensuring equitable outcomes). They are, in addition, about consensus-building and preventing social conflict.

The third conclusion is most relevant to the lessons that need to be drawn from an examination of the origins of the growth failures in many poorer countries, particularly in Africa. Institutional weaknesses and civil strife played an important role, but these cannot be analysed in isolation from the economic conditions prevailing in those countries. The prevalence of both growth failures and internal conflict seems to have been greatest among countries that are mineral exporters as compared with agricultural and manufactured goods exporters. Still, it cannot be concluded that growth collapses and conflict are the direct result of a dependence on revenues from natural resources. There must be other mechanisms at work, such as a weakening social contract and a withering State capacity. But the abundant availability of easily lootable mineral resources or illicit drugs can cause or perpetuate civil wars and conflicts. The very wealth that is producible in a short period of time by their exploitation can exacerbate social inequality and political conflict, including divides between the central Government and the local interests in the areas where the resources are located, or among different regions in one country. If strong institutions are not in place to resolve these issues right at the start of exploitation, violence can erupt and, in general, existing differences within society can be exacerbated if it is felt that the wealth is not being distributed justly. One of the major research findings of the present report is that this particular manifestation of the "natural resource curse" can be averted if countries have strong institutions that are able to manage and defuse conflicts.

Implications for governance reform policies

While governance reform is intrinsically difficult to implement, this analysis suggests at the same time that there is no justification for the pessimistic belief that certain countries will remain mired in low growth and shackled with institutions that impede their growth. Growth is indeed possible with initially imperfect institutions, but it is important in these circumstances that the Government itself be credibly committed to making changes that will remove the institutional obstacles to sustained growth. Governance reform is thus about creating well-functioning public institutions that are seen as legitimate by private agents. International cooperation can help, but only by supporting domestic processes that are inherently context-specific and gradual.

For the international community, this finding has particular relevance to countries that are emerging from conflict or have become "failed States". In most cases, the most important consideration is to foster the resumption of economic activity, which usually means the revival of the agricultural sector, inasmuch as a solid agricultural sector is usually essential for subsequent economic development. This will encourage further investment in that sector and raise farmers' incomes so that their own demand as directed towards the rest of the economy will increase. A prosperous agricultural sector can show that growth is indeed shared and so can help create a stable and just society. With economic growth comes the opportunity to adjust institutions and improve governance so that a virtuous circle is created.

Global inequality, security and the international development agenda

In today's increasingly integrated global economy, the growth performance of a country is determined by factors that operate both within and outside its geographical boundaries. Increased international trade and finance can contribute to better economic performance. However, countries with poorly integrated domestic economies, pro-cyclical macroeconomic policies, low infrastructural and human development and weak institutions have less opportunity to gain from expanding world markets. Their initial weaknesses tend to keep them stuck on a low-growth path and in consequence they fall further behind. These underlying reasons for the divergence, and thus for the increasing global inequality, also make it more difficult for them to grow out of poverty and increase their resilience to global shocks. This in turn will feed further international income disparities and could increase the risk of conflict. Conversely, countries that are able to promote both the external and internal integration of their economies and to conduct counter-cyclical macroeconomic policies, and that have well-developed human capital and infrastructure and strong institutions are in a better position to benefit from enhanced integration into the world economy and will be able to catch up with developed countries.

The problem of rising global inequality therefore has an important bearing on the implementation of the United Nations development agenda. It makes the achievement of the Millennium Development Goals and other internationally agreed development goals more difficult and affects global security. Failure to redress the tendency towards growing global inequality could thus have wide-ranging consequences for human development.

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