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Inclusive Growth for Sustainable Poverty Reduction in Developing Asia: The Enabling Role of Infrastructure Development

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Introduction

Sustaining and accelerating the course of poverty reduction requires stepping up efforts for inclusive growth. Past experience in developing Asia demonstrates the critical significance of inclusive growth for poverty reduction. By improving the access of the poor to markets, increasing productivity, and creating further opportunities for employment, inclusive growth mainstreams the poor to actively participate in the growth process, thereby contributing to raising their standards of living. The policy imperative for inclusive growth cannot be overemphasized as developing Asian economies confront the continuing challenges of globalization, structural transformation, and the need for regionally balanced growth within a country.

This brief discusses the role of infrastructure as an enabling factor for inclusive growth and sustainable poverty reduction. Quality of infrastructure is an essential element of the business and investment climate for catalyzing domestic private investment and foreign direct investment, adopting new technologies, and raising productivity. This is critical especially for those developing economies for which significant growth has been hampered by shortages of investment and technology. Substantial infrastructure investment is also essential to smooth out the continuing structural transformation of developing Asia, and particularly, to support technological advances in the agriculture sector and to develop rural economies in general. This will create significant opportunities for employment generation. Another area where infrastructure development contributes to inclusive growth is in market expansion. The expansion and efficient functioning of markets integrate poor areas into the overall growth process, contributing to reduction of regional economic disparities. While infrastructure plays a critical enabling role, appropriate incentives and institutions are essential complements. Indeed, inclusive growth calls for a right mix of incentives, institutions, and infrastructure.

Seizing and Capitalizing on Opportunities Created by Globalization

Globalization and rapidly increasing regional economic interdependence offer opportunities for larger markets, new technologies, and foreign direct investment. Developing Asian countries have benefited from these opportunities unevenly (Ali 2003). For those that face capital and technology constraints, attracting foreign direct investment and adopting new technologies from abroad are critical to breaking the trend of “low investment and low technology” growth, thus increasing productive capacity and accelerating growth. Indeed, in many countries, inadequate capital formation severely constrains growth potential. For example, gross domestic investment has been around only 15-16 percent of gross domestic product (GDP) in Indonesia and Pakistan. In the Philippines, the investment-to-GDP ratio has also been below 20 percent (ADB 2003).

Experience indicates that the ability of a country to seize and capitalize on the opportunities created by globalization depends on the presence of supportive domestic policies, institutions, and adequate infrastructure (ADB 2004). The right mix of incentives, institutions, and infrastructure constitutes the immobile factor of production in an economy. Its overall quality will determine the volume of investment and skilled labor needed—the mobile factors—which an economy or subregion can attract and maintain. Building up and improving the distribution of this immobile asset across countries and subregions in a country is at the core of efforts to strengthen the process of inclusive growth. Recent research suggests that if certain states in India would follow practices in the most progressive states in terms of improving the investment climate, the potential rate of growth of the Indian economy would increase by about 2 percentage points (World Bank 2002).

To boost investment by both domestic and foreign investors, public policy should specifically aim at improving the macro and microeconomic fundamentals of the economy. At the micro level, governments must tackle impediments to competition and entrepreneurship, and strengthen institutions such as legal systems. Public policies in this regard should aim to ensure a favorable business and investment climate.

The quality of infrastructure is a critical component for improving the business and investment climate. As countries address incentive and institutional constraints, they must also develop the necessary infrastructure and improve the provision of infrastructure services. Inadequate infrastructure raises the cost of doing business and discourages domestic and foreign private investment. An investment climate survey study of India founds that most small- and medium-size enterprises (SMEs) surveyed have their own power generators because of problems in unreliability of supply from the public power grid. Installation of own power generators represents a large investment (Stern 2002). A vibrant and dynamic SME sector needs an efficiently functioning public power grid. Efficient infrastructure also encourages foreign direct investment. As multinational firms develop local parts suppliers, for example, SME development gets a further boost. This illustrates the direct and indirect linkages of infrastructure with inclusive growth. SMEs account for the large majority of firms in many Asian developing economies. They employ a large share of labor including from the poor in rural and urban areas. A strong SME sector contributes significantly to inclusive growth.

The adoption of new technologies will open up new opportunities for entrepreneurs and make existing businesses more profitable. Innovations require an educated and creative work force, research and development, information technology, and dynamic urban clusters. Industrial clusters in large urban areas become the foci for medium and high-technology production (Yusuf 2003). To create such clusters, cities need to develop infrastructure, and improve public services and amenities. Quality of the environment is also vital. Traffic management and public transport need strengthening. All these require substantial investment.

Modernizing Agriculture and Scaling Up the Development of Rural Economies

Economic development is a process by which an economy is transformed from one that is dominantly rural and agricultural to one that is dominantly urban, industrial, and service-oriented. Past experience with this process of transformation in developing Asia has been mixed.

In many countries, the experience highlighted the need for active policy efforts to smooth the transformation process. While the rapid decline in the share of agriculture in GDP was compensated by corresponding increases in the share of manufacturing and services, the sector composition of the labor force has not shown similar changes. In the People's Republic of China, for example, while agriculture currently accounts for only 15 percent of GDP, 50 percent of the labor force is in agriculture (ADB 2003). As a consequence, there remains considerable surplus labor in the agriculture sector. Labor absorption outside agriculture has been constrained by a combination of factors, including low resource productivity in agriculture and underdeveloped rural economies. In India and the

Philippines, rural economies also continue to lag behind despite past attempts at development with integrated rural development programs. Thus, rural poverty continues to be the critical development concern.

A key component of the inclusive growth strategy is to modernize agriculture and to scale up the development of rural economies. The pace of agricultural growth needs to be accelerated primarily through technological change. Domestic demand for agricultural output needs to grow more rapidly through accelerated growth in nonagricultural rural employment. The demand for goods and services produced by labor-intensive processes must also increase. Together, they will reignite and sustain the development of agriculture and rural economies in a virtuous cycle that opens the opportunities for productivity improvements and employment (Mellor 1986).

Infrastructure development plays a significant role in this process of inclusive growth that focuses on developing agriculture and rural economies. With the size limit of agricultural land, the sources of productivity improvement will have to come from labor-absorbing technological advances. Development of a technology system and technical extension services are essential. The nature of agricultural technology and production systems is such that delivery systems of productive inputs will also have to develop. Thus, a highly developed network of roads, other transport, and communications will be required. Small-scale and labor-intensive irrigation infrastructure needs to be strengthened as well to support on-farm efficiency improvements. Developing rural economies through small- and medium-size industry and rural markets requires the support of infrastructure such as rural electrification, transport, communications, and water supply. In the absence of such basic infrastructure, the efforts to promote rural small and medium-size industry will be made much more difficult—a lesson in developing Asia that has recurred in many such attempts in the past.

Supporting Market Expansion and Efficient Functioning of Markets

The discussion above focused on the role of infrastructure in strengthening inclusive growth processes at country and sector levels. Implicit in the discussion is that volume of transactions in the product and factor markets must grow. Expansion and the efficient functioning of markets, in turn, must also have a positive feedback for accelerating economic growth. Both of these aspects highlight the role of infrastructure in supporting market enlargement and its efficient functioning.

Markets in many countries are fragmented due to poor infrastructure connections. Markets with poor infrastructure can coordinate supply and demand only within a limited geographic area. The high cost of moving goods and providing services becomes a barrier to trade on a large scale. Poor transport and communications services inhibit the efficient flow of information among market participants, especially those in distant locations. Small market size and the lack of interconnectivity with outside markets limit the scope for productivity improvements and commercial production.

Many countries have been reforming pricing policies that distort markets. As reforms progress, infrastructure bottlenecks emerge as a critical binding constraint to the efficient functioning of product and factor markets. Therefore, unless bottlenecks are removed, the positive effects expected from pricing policy changes will not be fully realized.

Development of a well-connected and integrated market system should improve access to markets, products, inputs and other services, thus reducing transportation and transaction costs and facilitating exchange. Clearly, many other factors besides infrastructure affect the extent to which markets can function efficiently. Nevertheless, infrastructure development is essential to strengthen interconnectivity between markets and increase market size (Yao 2003).

In many developing Asia economies, there are significant regional differences in the rates of growth and poverty reduction. Detailed subnational studies in the PRC and India found that a significant proportion of poverty in poor areas is due to the infrastructure deficiency and lack of access to outside markets, and that substantial amounts of public investments are required in poor areas to develop infrastructure and improve market access. By enabling product and factor markets to expand, infrastructure development contributes to spreading growth process across the economy and mainstreaming people and regions that would have been otherwise bypassed. Moreover, unless the poor are given the opportunity to escape poverty, their living standards are unlikely to improve.

Conclusions

This brief discusses the role of infrastructure development as a critical enabling factor for inclusive growth to achieve sustainable poverty reduction. The three different but closely related perspectives presented in this regard highlight the policy direction for substantially increasing infrastructure investment in developing Asian economies.

Mobilizing resources to finance infrastructure presents a significant challenge, especially for those economies under severe fiscal stress. However, the provision of quality infrastructure services goes beyond infrastructure financing. It also involves addressing issues of incentives and institutions within the infrastructure sectors. These have to be addressed through a combination of policy measures at the macro and sectoral levels. Fiscal consolidation may be required to rein in large budget deficits. Greater effort is also needed to review and establish public expenditure and investment priorities. At the sector level, the investment climate of the infrastructure sectors will need to be significantly improved. In particular, policy and institutional reforms will need to be accelerated with respect to the legal and regulatory framework for infrastructure investment and operation. An improved macroeconomic framework and sector investment climate will enhance prospects for attracting alternative sources of financing and encouraging public-private partnerships in investing and managing the provision of infrastructure services.

Rural infrastructure development poses additional policy and institutional challenges. First, it will require a refocusing of development priorities to the agriculture and rural areas. In the past, governments at the national and local levels have not organized or allocated adequate resources for the massive rural infrastructure that is essential for agricultural and rural employment growth. Second, as many countries are pursuing fiscal decentralization, financing rural infrastructure and managing service provision will involve multiple players from different levels of government. This underscores the importance of addressing infrastructure, incentives, and institutions at the same time.

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