

# Closing Development Gaps: Challenges and Policy Options

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There are significant income and nonincome development gaps around the world. Closing these gaps will require not only increasing and sustaining economic growth in low-income regions, but also policies that close nonincome development gaps directly. Governments need to support private investment and entrepreneurship by investing in human capital and infrastructure; developing the financial sector; improving governance; and eliminating other impediments created by market, institutional, or policy failures. Policy makers should improve access to and quality of health, education, and other social services. This means better targeting and increased public spending on social services that directly benefit the poor; innovative delivery mechanisms informed by rigorous evaluation; and social protection systems. The experience of developing Asia and others has shown that external trade and finance—including foreign direct investment, remittances, and aid—play a critical role. It is therefore imperative that governments continue to promote globalization and regional integration.

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## I. INTRODUCTION

Even though many low-income economies have expanded strongly in recent years, catching up significantly to more developed regions, global development gaps remain large. In 2007, for instance, sub-Saharan Africa's average per capita income (in 2005 purchasing power parity [PPP] terms) was only 5%, life expectancy at birth 63%, and adult literacy 70% that of members of the Organisation for Economic Co-operation and Development (OECD). Income poverty, whether measured by the \$1.25-a-day or \$2-a-day poverty lines, also varies considerably across regions.

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In developing Asia, a major engine of global economic growth in recent years, closing these development gaps remains a major challenge. Some 40% of South Asians, for example, still live in extreme poverty, while developing Asia's progress on the nonincome targets of the Millennium Development Goals (MDGs) has been slow. The recent global economic crisis has made progress even harder.

This paper aims to highlight important dimensions of these development gaps and to examine the policy options for closing them. It argues that sustaining rapid economic growth is necessary, but not enough. Closing the gaps requires policies that not only increase and sustain economic growth, but also reduce the nonincome development gaps directly through investment in education and health, and provision of social protection. In this regard, the challenge is to provide sufficient finance as well as better governance in the delivery of public services. These goals are in keeping with the Asian Development Bank's (ADB) Strategy 2020, which among other things, reaffirms ADB's support for reducing poverty and helping countries improve living standards, including through inclusive growth.<sup>1</sup>

This paper focuses largely on the requirements for inclusive growth (Zhuang 2010). In Section II, we first discuss development gaps in various regions, focusing on per capita income, life expectancy at birth, adult literacy, net primary school enrollment, under-5 survival, and proportion of births attended by skilled personnel,<sup>2</sup> using the OECD as a benchmark. In particular, we look at the number of years required to close these gaps based on the historical relationship between economic growth and development outcomes. Section III then looks at the key policy elements of a strategy for sustained growth to close these gaps, including human capital, infrastructure, financial sector development, and governance and institutions. Section IV discusses the nonincome development gaps and how these can be closed. Section V looks at the role of social protection in closing income and nonincome development gaps. Section VI examines the role of external trade and finance—including foreign direct investment (FDI), remittances, and foreign aid—in supporting economic growth. Finally, Section VII highlights possible elements of the development agenda for the global community.

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<sup>1</sup>ADB's Strategy 2020 explains inclusive growth as having two mutually reinforcing strategic focuses: (i) high, sustainable growth that will create and expand economic opportunities; and (ii) broader access to these opportunities that will ensure members of society can participate in and benefit from growth. Proper attention and planning are necessary for growth to reach the impoverished who have remained excluded by circumstance, poor governance, and other market-resistant obstacles (ADB 2008).

<sup>2</sup>These indicators capture key dimensions of income and nonincome development gaps.

## II. KEY DIMENSIONS OF DEVELOPMENT GAPS

While the growth of gross domestic product (GDP) is a popular measure of economic growth, it is not a sufficient yardstick for development. Development is about many different things, including command over resources, choice of livelihood, human capabilities, living in a healthy and safe environment, adequate housing and food, political freedom, and many others. In other words, economic growth is important to, but not the only driver of, development. Sen (1985, 28) points out, “Ultimately, the focus has to be on what we can or cannot do, can or cannot be.” Thus, development must be defined by an individual’s achievements and by the means that the individual possesses.

While there are many ways to measure development gaps and achievements, this section focuses on eight indicators; namely, \$1.25-a-day poverty, \$2-a-day poverty, per capita GDP at 2005 PPP, life expectancy at birth, net primary enrollment, adult literacy, under-5 survival, and births attended by skilled health personnel. From these indicators, one can gauge people’s command over resources, nutritional levels, use of health and education services, access to clean water and sanitation, and others.<sup>3</sup>

As shown in Table 1, there is considerable disparity in the level of development across regions, and the disparity in per capita income is far greater than in other indicators. Sub-Saharan Africa is the poorest region, with more than half of its population living in extreme poverty, and with a per capita GDP at only 19.8% of the world average in 2007. Its life expectancy at birth, the world’s lowest, is 74.5% of the world average and 65.1% that of OECD countries.

In 2007, about half of developing Asia’s population lived below the \$2-a-day poverty line. Developing Asia’s per capita income was only 10% that of OECD countries, and life expectancy was 10 years shorter. Some 41.4 more children below 5 years old per 1,000 population die in developing Asia than in OECD countries every year. Within developing Asia, there is also significant disparity in both income and nonincome development indicators. About 74% of South Asians lived below \$2 a day in 2007, compared to about 40% in East Asia and the Pacific and in Central Asia. South Asia’s per capita income was less than 7% of the OECD average. Among nonincome indicators, South Asia’s life expectancy at birth was 63.8 years, compared to East Asia and the Pacific’s 71.3 years; its proportion of births attended by skilled health personnel was 39.9%, compared to Central Asia’s 95.4%; and its adult literacy was 61.1%, compared to Central Asia’s 98.5%.

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<sup>3</sup>The selected eight indicators are closely related to the MDGs. More specifically, these indicators are reflected in MDGs 1, 2, 4, 5, and 6 (see UNDP 2000).

Table 1. Key Development Indicators, 2007

| Region/Subregion                   | Headcount Index (%)    |                     | GDP per Capita at 2005 PPP (US\$) | Life Expectancy at Birth (year) | Adult Literacy (%) | Net Primary Enrollment (%) | Under-5 Survival (per 1000) | Births Attended by Skilled Personnel (%) |
|------------------------------------|------------------------|---------------------|-----------------------------------|---------------------------------|--------------------|----------------------------|-----------------------------|--|
|                                    | (\$1.25-a-day poverty) | (\$2-a-day poverty) |                                   |                                 |                    |                            |                             |  |
| Developing Asia                    | 27.0                   | 53.9                | 3,060.9                           | 68.1                            | 79.1               | 89.2                       | 948.4                       | 69.2                                     |
| Eastern Europe                     | 0.7                    | 3.0                 | 9,932.2                           | 68.8                            | 99.2               | 92.5                       | 983.1                       | 99.4                                     |
| Latin America and Caribbean        | 8.2                    | 17.1                | 7,719.3                           | 72.1                            | 90.1               | 94.2                       | 973.7                       | 89.2                                     |
| Middle East and North Africa       | 3.6                    | 16.9                | 8,255.6                           | 70.5                            | 73.6               | 89.7                       | 962.6                       | 79.7                                     |
| Sub-Saharan Africa                 | 50.9                   | 72.9                | 1,698.1                           | 50.8                            | 61.2               | 67.1                       | 851.9                       | 46.5                                     |
| OECD                               | —                      | —                   | 29,607.6                          | 78.0                            | 93.2               | 96.6                       | 989.8                       | 97.2                                     |
| World                              | 25.2                   | 47.0                | 8,588.8                           | 68.2                            | 78.8               | 86.8                       | 948.5                       | 74.1                                     |
| Within Developing Asia             |                        |                     |                                   |                                 |                    |                            |                             |  |
| East Asia and Pacific <sup>a</sup> | 16.8                   | 38.7                | 3,857.7                           | 71.3                            | 91.7               | 94.0                       | 968.9                       | 90.0                                     |
| South Asia                         | 40.3                   | 73.9                | 1,959.9                           | 63.8                            | 61.1               | 82.6                       | 920.3                       | 39.9                                     |
| Central Asia                       | 19.2                   | 40.2                | 3,551.5                           | 67.1                            | 98.5               | 90.4                       | 954.1                       | 95.4                                     |

— means not available.

<sup>a</sup> Includes East Asia (but excluding Japan and Republic of Korea), Southeast Asia, and the Pacific.

OECD = Organisation for Economic Co-operation and Development; PPP = purchasing power parity.

Note: Poverty rates (in 2005 PPP) are for 2005 and are based on PovcalNet Database (World Bank 2010b).

Sources: Authors' calculations based on World Development Indicators Online Database (World Bank 2010c), PovcalNet Database (World Bank 2010b).

Another way to understand the magnitude of development gaps is to calculate the number of years required for the regions to catch up with OECD countries on selected development indicators. To do this, we first calculate the elasticity of the selected development indicators to economic growth for each country.<sup>4</sup> Based on this elasticity and historical economic growth performance, we can estimate a country's progress. Table 2 presents estimates of growth elasticity of well-being using data for 177 countries. We find that a 1% growth in the global economy increases the world's life expectancy at birth by 0.04%, that is, the average person will live 11 days longer. On the other hand, a 1% growth will increase average lifespan by 21 days in sub-Saharan Africa where, given its current low life expectancy, even a small increase will improve life expectancy more substantially. Likewise, a 1% growth in South Asia will increase the average lifespan in the region by 14 days. Table 2 shows that higher incomes in developing countries will help relax resource constraints that may be impeding the effective delivery of health services, especially among the poor. Moreover, the impact of economic growth on well-being is greater in poorer than in richer countries, indicating the possibility for closing the gaps.

Table 2. Average Growth Elasticity of Well-being, 2007

| Region/Subregion                   | Life Expectancy at Birth | Adult Literacy | Net Primary Enrollment | Under-5 Survival Rate | Births Attended by Skilled Personnel |
|------------------------------------|--------------------------|----------------|------------------------|-----------------------|--------------------------------------|
| Developing Asia                    | 0.04                     | 0.10           | 0.03                   | 0.02                  | 0.21                                 |
| Eastern Europe                     | 0.04                     | 0.02           | 0.02                   | 0.01                  | 0.02                                 |
| Latin America and Caribbean        | 0.03                     | 0.04           | 0.02                   | 0.01                  | 0.06                                 |
| Middle East and North Africa       | 0.04                     | 0.13           | 0.03                   | 0.01                  | 0.12                                 |
| Sub-Saharan Africa                 | 0.11                     | 0.23           | 0.13                   | 0.06                  | 0.53                                 |
| OECD                               | 0.02                     | 0.03           | 0.01                   | 0.00                  | 0.01                                 |
| World                              | 0.04                     | 0.10           | 0.04                   | 0.02                  | 0.16                                 |
| Within Developing Asia             |                          |                |                        |                       |                                      |
| East Asia and Pacific <sup>a</sup> | 0.03                     | 0.03           | 0.02                   | 0.01                  | 0.05                                 |
| South Asia                         | 0.06                     | 0.23           | 0.06                   | 0.03                  | 0.70                                 |
| Central Asia                       | 0.05                     | 0.02           | 0.03                   | 0.02                  | 0.02                                 |

<sup>a</sup> Includes East Asia (but excluding Japan and Republic of Korea), Southeast Asia, and the Pacific.

OECD = Organisation for Economic Co-operation and Development.

Source: Authors' calculations.

<sup>4</sup>The elasticity is calculated by regressing the achievement function of a country with a given indicator of well-being (for instance, life expectancy at birth) on the logarithm of countries' per capita GDP. This model, proposed by Kakwani (1993), takes into account countries' initial levels of well-being, which implies that the elasticity decreases as a country achieves higher well-being. The use of the achievement function as a dependent variable captures the important nonlinearity characteristics of indicators of well-being.

Using these elasticities and future growth paths—based on historical performance for 2000–2007—we can estimate a country’s progress in these indicators. Assuming these average growth rates can be sustained, we can estimate the years it will take to catch up with current OECD income and living standards.<sup>5</sup> Table 3, columns 3–8, present these estimates.

Table 3. **Convergence toward Levels of Well-being in OECD Countries**

| Region/Subregion                   | Average Annual Growth Rate (2000–2007, %) | Number of Years for Convergence |                          |                |                        |                       |                                      |
|------------------------------------|---|---------------------------------|--------------------------|----------------|------------------------|-----------------------|--------------------------------------|
|                                    |   | GDP per Capita at 2005 PPP      | Life Expectancy at Birth | Adult Literacy | Net Primary Enrollment | Under-5 Survival Rate | Births Attended by Skilled Personnel |
| Developing Asia                    | 6.82                                      | 34.5                            | 31.7                     | 20.0           | 27.2                   | 29.5                  | 33.0                                 |
| Eastern Europe                     | 6.11                                      | 18.4                            | 33.5                     | 0.0            | 20.7                   | 10.2                  | 5.5                                  |
| Latin America and Caribbean        | 2.24                                      | 60.7                            | 66.0                     | 20.1           | 38.1                   | 52.3                  | 56.4                                 |
| Middle East and North Africa       | 2.91                                      | 44.5                            | 60.8                     | 55.9           | 60.8                   | 55.2                  | 63.7                                 |
| Sub-Saharan Africa                 | 3.09                                      | 93.9                            | 128.4                    | 67.6           | 117.3                  | 107.1                 | 89.4                                 |
| OECD                               | 1.50                                      | 0.0                             | 0.0                      | 0.0            | 0.0                    | 0.0                   | 0.0                                  |
| World                              | 5.01                                      | 25.3                            | 42.7                     | 27.2           | 43.2                   | 40.0                  | 41.6                                 |
| Within Developing Asia             |   |                                 |                          |                |                        |                       |                                      |
| East Asia and Pacific <sup>a</sup> | 7.82                                      | 27.1                            | 20.8                     | 3.1            | 11.6                   | 17.6                  | 15.2                                 |
| South Asia                         | 5.43                                      | 51.3                            | 50.3                     | 38.5           | 48.0                   | 46.8                  | 52.9                                 |
| Central Asia                       | 8.13                                      | 27.1                            | 28.3                     | 0.0            | 20.4                   | 22.9                  | 5.7                                  |

<sup>a</sup> Includes East Asia (but excluding Japan and Republic of Korea), Southeast Asia, and the Pacific.

OECD = Organisation for Economic Co-operation and Development; PPP = purchasing power parity.

Source: Authors’ calculations.

As seen in Table 3, column 3, it will take the world 25.3 years to catch up with the current OECD per capita income (in 2007); sub-Saharan Africa, 93.9 years; and developing Asia, 34.5 years.<sup>6</sup> Applying the growth elasticities of nonincome well-being to the above economic growth estimates, results suggest that it will take decades for developing Asia to catch up with the OECD’s development indicators achieved in 2007. It will take developing Asia 20 years to catch up with the current OECD level in terms of adult literacy, 27 years in terms of primary enrollment, 30 years in terms of under-5 survival, 32 years in terms of life expectancy, and 33 years in terms of births attended by skilled personnel. The data also show that it may not be possible to achieve universal primary education by 2015 (that is, Goal 2 of the MDGs); even in East Asia and the Pacific it will

<sup>5</sup>Note that these calculations take into account the fact that the elasticity of well-being indicators decreases as countries achieve higher well-being over time, which means that the countries cannot go on increasing their well-being at the same rate.

<sup>6</sup>The results are based on the assumption that countries in the different regions will have constant economic growth rates over time based on their trend growth rate for 2000–2007. The number of years is calculated for converging to the “current” level (i.e., 2007 in this case) of OECD economies.

take 11.6 years to achieve this goal, while it will take South Asia almost half a century. Within developing Asia, South Asia has the largest development gaps in all the dimensions.

Note that these calculations assume that while per capita GDP grows over time, other factors that may influence standards of living—such as technology or public policy—remain constant. As such, our calculations estimate how long it will take for trickle-down economics to improve living standards. We have shown that income and standards of living are strongly associated, particularly in low-income countries. Thus, promoting rapid economic growth will help close the development gaps.

However, although economic growth alone can improve standards of living, the results also suggest that it will take an exceptionally long time for some countries to close the development gaps if growth rates remain at 2000–2007 levels. Therefore, governments in developing countries will need to implement policies that promote growth and broaden access to the opportunities that growth creates.

### **III. ECONOMIC GROWTH AS A MEANS TO CLOSING DEVELOPMENT GAPS**

While economic growth is not an end in itself, it enables the achievement of basic development goals. It expands economic opportunity for individuals and societies; frees people from hunger, poverty, and misery; and creates the resources required for health care, education, and social protection. In other words, though not a sufficient condition for broad-based development, it is a necessary condition (Commission on Growth and Development 2008). Indeed, many empirical studies find that economic growth is the most effective way toward sustained poverty reduction (Ravallion 2001).

But experience varies significantly. Some countries have sustained growth for considerable periods of time, some have experienced growth spurts but failed to sustain them, and others have been trapped in low-growth trajectories. While our understanding of the determinants of these cross-country differences is far from complete, there are a number of important policy ingredients of a strategy for sustained growth. This section focuses on the role of human capital, infrastructure, financial sector development, and governance and institutions in fostering economic growth and closing development gaps. An examination of cross-country data suggests that there are huge differences in all these dimensions around the world.

## A. Human Capital

It is widely accepted that directly improving well-being, health, and education has intrinsic value. But it also has instrumental value. Barro and Lee (2010b) show that the rate of return from an additional year of schooling, for example, ranges from 5% to 12%. Using data on cognitive skills provided by schooling, Hanushek and Woessmann (2008) argue that there is a robust association between cognitive skills and economic growth, and that this is driven by a causal impact from cognitive skills. Similarly, Jamison, Jamison, and Hanushek (2006), using a 62-country dataset at 10-year intervals from 1960 to 2000, show that the quantity of schooling has a strong positive effect on growth once one incorporates information on the quality of schooling. Their estimates show that a 1 standard deviation increase in test scores can increase annual growth in per capita income by 0.5–0.9 percentage point.

Education improves labor productivity, facilitates technological innovation, increases returns to capital, and helps improve health outcomes. Furthermore, studies show that access to basic education enables farmers to switch from traditional to more productive modern techniques, and from farming to nonfarming activities (Foster and Rosenzweig 1996).

Similarly, good health can improve growth by boosting human capital accumulation—healthy individuals have a greater capacity to learn skills and to exploit them economically, and are more productive because they are able to work longer hours. Indeed, empirical studies find that better health leads to higher economic growth. Weil (2006) estimates that eliminating health gaps between countries would reduce the variance of log GDP per worker by 9.9% and would reduce the ratio of GDP per worker at the 90th percentile to that of the 10th percentile from 20.5 to 17.9. Moreover, Bloom and Canning (2005) find that when the adult survival rate increases by 1 percentage point, labor productivity increases by about 2.8%.

## B. Infrastructure

No country has sustained economic growth without also keeping up an impressive rate of investment in infrastructure. Roads, water supply, sewerage systems, power grids, and telecommunications are vital inputs to the production of goods and services; and facilitate trade and factor mobility, reduce business costs, allow the exploitation of economies of scale, and improve efficiency and productivity.

There is strong empirical evidence that infrastructure development contributes significantly to economic growth. Using data covering over 100 countries during 1960–2000, Calderon and Servén (2004) find that an increase of 1 standard deviation in the index of infrastructure stocks would raise per capita

income growth by 2.9 percentage points. A similar increase in the infrastructure quality index would raise growth by 0.68 percentage point.

But the data on infrastructure investment are rather patchy. Available data suggest that in fast-growing Asian countries such as the People's Republic of China (PRC), Thailand, and Viet Nam, total infrastructure investment exceeds 7% of GDP. But many developing countries invest only 2% of GDP (Commission on Growth and Development 2008). The Global Competitiveness Report (World Economic Forum 2008) also shows the considerable disparity in infrastructure across regions in 2008–2009: the overall infrastructure score was highest for the OECD countries at 5.32 out of a maximum score of 7, and lowest in sub-Saharan Africa at 3.24 (Table 4).

Table 4. **Infrastructure Indicators**

| Region/<br>Subregion                  | Overall<br>Infra-<br>structure<br>Score, <sup>a</sup><br>2008/09 | Roads                                       |  |                                | Electricity   |  | Telecom-<br>munication                             |
|---------------------------------------|--|---|--|--------------------------------|---|--|--|
|                                       |  | Road<br>Density,<br>Latest<br>(km/sq<br>km) | Quality<br>of Roads, <sup>a</sup><br>2008/09 | Paved<br>Roads,<br>2006<br>(%) | Electricity<br>Consumption,<br>2006<br>(kWh/<br>capita) | Quality of<br>Electricity, <sup>a</sup><br>2008/09 | Phone Lines,<br>2007/08<br>(per 100<br>population) |
| Developing Asia                       | 3.90   | 0.369                                       | 3.99   | 54.91                          | 1,976   | 4.02   | 66.42  |
| Eastern Europe                        | 3.40   | 0.772                                       | 3.25   | 81.70                          | 3,459   | 4.56   | 130.42   |
| Former Soviet<br>Union <sup>b</sup>   | 3.87   | 0.070                                       | 3.25   | 76.09                          | 3,047   | 4.29   | 87.80  |
| Latin America<br>and Caribbean        | 3.75   | 0.158                                       | 3.59   | 37.45                          | 1,630   | 4.34   | 91.56  |
| Middle East                           | 4.99   | 0.116                                       | 5.00   | 82.38                          | 7,600   | 5.39   | 111.31   |
| North Africa                          | 3.84   | 0.069                                       | 3.72   | 44.28                          | 1,235   | 5.08   | 88.60  |
| OECD                                  | 5.32   | 0.082                                       | 5.05   | 77.25                          | 9,469   | 6.11   | 150.54   |
| Sub-Saharan<br>Africa                 | 3.24   | 0.495                                       | 3.17   | 20.45                          | 418   | 3.23   | 38.12  |
| Within Developing Asia                |  |   |  |                                |   |  |  |
| Central and<br>West Asia <sup>c</sup> | 3.20   | 0.114                                       | 3.70   | 47.33                          | 480   | 2.20   | 36.21  |
| East Asia                             | 4.60   | 0.321                                       | 4.50   | 83.00                          | 2,505   | 5.18   | 106.79   |
| Pacific                               | 2.30   | 0.057                                       | 1.90   | —                              | —   | 2.00   | 48.16  |
| South Asia                            | 3.00   | 1.095                                       | 3.00   | 48.70                          | 282   | 2.73   | 49.94  |
| Southeast<br>Asia                     | 4.29   | 0.274                                       | 4.28   | 49.05                          | 2,661   | 4.58   | 76.78  |

<sup>a</sup>Ranges from 1 (extremely underdeveloped) to 7 (extensive and efficient by international standards).

<sup>b</sup>Former Soviet Union includes Belarus, Moldova, Russian Federation, and Ukraine.

<sup>c</sup>Central and West Asia includes Afghanistan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

km/sq km = kilometers per square kilometer, kWh = kilowatt-hour,  
OECD = Organisation for Economic Co-operation and Development.

Note: Figures are weighted averages, except those pertaining to scores and quality, which are simple averages.

Source: World Development Indicators Online Database (World Bank 2010c), Global Competitiveness Report 2009–2010 (World Economic Forum 2008).

Road density also varies significantly, ranging from 0.772 kilometers per square kilometer in Eastern Europe, to about 0.069 in North Africa. The percentage of paved roads is also very low in some countries: only 20.45% of roads are paved in sub-Saharan Africa, compared with 82.38% in the Middle East, 81.70% in Eastern Europe, and 77.25% in OECD. Overall road quality is highest in the OECD with an average score of 5.05 (out of a highest possible score of 7), closely followed by the Middle East (5.00), and lowest in sub-Saharan Africa (3.17).

In electricity supplies and services, per capita electricity consumption ranged from 9,469 kilowatt-hours in the OECD to just 418 kilowatt-hours in sub-Saharan Africa. For developing Asia and North Africa, per capita electricity consumption is only 20.9% and 13%, respectively, that of the OECD. Overall quality of electricity services also varies: it is highest in the OECD at 6.11, 4.02 in developing Asia, and just 3.23 in sub-Saharan Africa. In telecommunications, the number of telephone lines per 100 people was highest in OECD countries (150.54) and lowest in sub-Saharan Africa (38.12).

Within developing Asia, the gaps in infrastructure stock and quality are also significant. East Asia has the highest overall infrastructure score at 4.60 (next only to the OECD and Middle East), followed by Southeast Asia at 4.29, Central and West Asia at 3.20, South Asia at 3.00, and the Pacific at only 2.30 (lower than sub-Saharan Africa). East Asia performs best in most categories of infrastructure, except for road density and electricity consumption. Southeast Asia ranks second in all subcategories of infrastructure, except for road density, where it ranks third, and electricity consumption, where it ranks first. South Asia ranks first in road density, third in telecommunication, quality of electricity and paved roads, but fourth in electricity consumption and quality of roads. The Pacific has the lowest score in all indicators, except telecommunications.

### **C. Financial Sector Development**

A well-developed financial sector supports economic growth by mobilizing and pooling savings; effectively transmitting information to enhance resource allocation; exerting influence to improve corporate governance; facilitating trading, diversification, and management of risks; and promoting exchange of goods and services. There is also a consensus that financial sector development contributes to poverty reduction directly by broadening the access of poor and vulnerable groups to credit, and indirectly through economic growth (see Zhuang et al. 2009 for a review of literature). However, rapid financial market deregulation and liberalization, which are often essential elements for financial sector development and innovation, may expose economies to external shocks and crises, which can hurt growth. It is therefore essential to maintain sound macroeconomic management, and put in place an effective regulatory and

supervisory framework while carrying out structural reforms in developing the financial sector.

A large number of empirical studies have provided evidence on the positive contribution of financial sector development to growth. King and Levine (1993a and 1993b) show that increasing financial depth (measured by the ratio of liquid liabilities to GDP) from the mean of the slowest-growing quartile of countries to the mean of the fastest-growing quartile would increase a country's per capita income growth rate by almost 1 percentage point per year. Given that the difference in average annual growth rate between these sets of countries is about 5 percentage points over 1960–1989, they argue that the difference in the depth of the financial sector alone could explain about 20% of this growth difference. A more recent study shows that such relationships hold true even after controlling for simultaneity bias (Levine, Loayza, and Beck 2000). Mavrotas and Son (2006) further find that the effect of financial sector development on economic growth in developing countries is more persistent and larger than in developed countries.

Financial sector development also contributes to poverty reduction indirectly through economic growth. Ravallion and Chen (1997) show that a 10% increase in the mean standard of living leads to an average reduction of 31% in the proportion of the population below the poverty line, indicating that economic growth leads to a reduction in poverty incidence. A number of empirical studies find a more direct relationship between financial sector development and poverty and inequality reduction. For example, Honohan (2004) shows that a 10 percentage point increase in the ratio of private credit to GDP would lead to a 2.5–3.0 percentage point reduction in poverty incidence.

Measured in terms of the ratio of money supply to GDP (Table 5), developing Asia had the greatest financial depth in 2007 at 116%, even exceeding OECD at 100%. However, this was mainly due to East Asia at 153%. Other subregions of developing Asia lag far behind: it was only 39% for Central and West Asia, 49% for the Pacific, 66.5% for South Asia, and 76.5% for Southeast Asia. An alternative measure, ratio of domestic credit to private sector to GDP, provides a similar picture. The only difference is that the ratio for OECD (157.3%) is much higher than that of developing Asia and of East Asia.

Table 5. **Financial Development Indicators**

| Region/Subregion                   | Money Supply, M2<br>(% of GDP) | Domestic Credit to Private<br>Sector (% of GDP) |
|------------------------------------|--------------------------------|---|
|                                    | 2007                           | 2007  |
| Developing Asia                    | 115.9                          | 87.1  |
| Eastern Europe                     | 48.7                           | 88.4  |
| Former Soviet Union <sup>a</sup>   | 37.8                           | 40.7  |
| Latin America and Caribbean        | 45.7                           | 42.0  |
| Middle East                        | 60.0                           | 59.7  |
| North Africa                       | 67.4                           | 36.4  |
| Sub-Saharan Africa                 | 38.0                           | 68.3  |
| OECD                               | 100.1                          | 157.3   |
| Within Developing Asia             |                                |   |
| Central and West Asia <sup>b</sup> | 39.0                           | 38.8  |
| East Asia                          | 152.8                          | 112.3   |
| Pacific                            | 49.0                           | 31.6  |
| South Asia                         | 66.5                           | 46.4  |
| Southeast Asia                     | 76.5                           | 40.5  |

<sup>a</sup>Former Soviet Union includes Belarus, Moldova, Russian Federation, and Ukraine.

<sup>b</sup>Central and West Asia includes Afghanistan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

Source: World Development Indicators Online Database (World Bank 2010c).

Nevertheless, for many of the region's poor, access to some form of formal financial services is still uncommon. A large part of Asia's adult population remains financially excluded. Yet, it is for these same people in which access to financial services is critical. Empirical evidence suggests that improved financial access can reduce poverty and income inequality. The availability of financing can jumpstart the process of escaping poverty, but it remains a key constraint for many developing countries.

#### **D. Governance and Institutions**

The long-run positive association between governance and institutional quality on one hand, and economic growth and income levels on the other, is strong both conceptually and empirically. The two-way causal link between the two is now well recognized. Institutions and governance are factors that drive economic growth because the enforcement of property rights and contracts allows market exchange, investment, and innovation over wider economic spheres and geographical areas through lower transaction costs (Acemoglu et al. 2001, North 1990). Conversely, economic growth can lead to better institutions because rising incomes and education levels create a demand for better governance and accountability.

Accountability, rule of law, political stability, bureaucratic capability, property rights protection and contract enforcement, and control of corruption are now regarded as crucial, mutually reinforcing aspects of growth-enhancing

institutions. A recent study of the links between institutional quality and economic growth finds that developing Asian economies with above-average scores (after controlling for per capita income) in government effectiveness, regulatory quality, and rule of law in 1998 grew faster during 1998–2008 by 1.6, 2.0, and 1.2 percentage points per year on average, respectively, compared with the economies that scored below average in these dimensions<sup>7</sup> (Zhuang, de Dios, and Lagman-Martin 2010).

The World Bank's latest worldwide governance indicators show that, in 2008, OECD countries had the highest average score in all six dimensions of governance<sup>8</sup> (Table 6). Developing Asia scored lower than the OECD grouping and Eastern Europe in all six dimensions, and lower than Latin America and Caribbean in all dimensions except government effectiveness and rule of law. On the other hand, developing Asia scored higher than sub-Saharan Africa in all dimensions except voice and accountability, higher than the former Soviet Union in all dimensions except political stability, and higher than the Middle East and North Africa in all dimensions except control of corruption and political stability. Across the six dimensions of governance, developing Asia scored relatively high in government effectiveness and rule of law, but relatively low in political stability and in voice and accountability.

Compared with the OECD and Eastern Europe, developing Asia still has a lot of room to catch up on all governance dimensions. In 1998–2008, however, a large number of developing Asian economies saw their governance scores improve in various dimensions, although a large number of economies also slipped. Many developing Asian economies improved their scores in the areas of rule of law and control of corruption, suggesting that significant improvements in governance do and can occur within a relatively short period of time.

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<sup>7</sup>This analysis excludes oil- and gas-rich countries.

<sup>8</sup>Scores ranging from –2.5 (worst) to 2.5 (best) are based on about 30 opinion/perception-based surveys and are classified into six dimensions: (i) voice and accountability; (ii) political stability and absence of violence; (iii) government effectiveness; (iv) regulatory quality; (v) rule of law; and (vi) control of corruption (Kaufmann, Kraay, and Mastruzzi 2009).

Table 6. Worldwide Governance Indicators

| Region/<br>Subregion                  | Voice and<br>Accountability | Political<br>Stability | Government<br>Effectiveness | Regulatory<br>Quality | Rule<br>of Law | Control of<br>Corruption |
|---------------------------------------|-----------------------------|------------------------|-----------------------------|-----------------------|----------------|--------------------------|
| Developing Asia                       | -0.72                       | -0.78                  | -0.05                       | -0.35                 | -0.27          | -0.43                    |
| Eastern Europe                        | 0.46                        | 0.20                   | 0.03                        | 0.05                  | -0.03          | -0.35                    |
| Former Soviet<br>Union <sup>a</sup>   | -0.77                       | -0.43                  | -0.43                       | -0.65                 | -0.84          | -0.89                    |
| Latin America<br>and Caribbean        | 0.17                        | -0.41                  | -0.15                       | 0.25                  | -0.51          | -0.17                    |
| Middle East<br>and North Africa       | -1.21                       | -0.77                  | -0.39                       | -0.63                 | -0.31          | -0.28                    |
| OECD                                  | 0.95                        | 0.49                   | 1.25                        | 1.10                  | 1.14           | 1.21                     |
| Sub-Saharan<br>Africa                 | -0.63                       | -1.05                  | -0.75                       | -0.70                 | -0.83          | -0.80                    |
| Within Developing Asia                |                             |                        |                             |                       |                |                          |
| Central<br>and West Asia <sup>b</sup> | -1.12                       | -1.93                  | -0.69                       | -0.74                 | -0.94          | -0.87                    |
| East Asia                             | -1.64                       | -0.27                  | 0.24                        | -0.26                 | -0.30          | -0.31                    |
| Pacific                               | 0.11                        | -0.37                  | -0.75                       | -0.54                 | -0.74          | -0.57                    |
| South Asia                            | 0.29                        | -1.09                  | -0.13                       | -0.41                 | 0.00           | -0.36                    |
| Southeast Asia                        | -0.66                       | -0.83                  | -0.25                       | -0.24                 | -0.53          | -0.72                    |

<sup>a</sup>Former Soviet Union includes Belarus, Moldova, Russian Federation, and Ukraine.

<sup>b</sup>Central and West Asia includes Afghanistan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

OECD = Organisation for Economic Co-operation and Development.

Source: Means of each region/subregion are computed from the Worldwide Governance Indicators (World Bank 2010d) and weighted by population based on the World Development Indicators Online Database (World Bank 2010c).

## E. Strategy for Sustaining Economic Growth

The above discussions show that there are significant gaps in the availability and quality of infrastructure and human capital, in the depth of the financial sector, and in the governance and institutional quality across regions around the world. Narrowing and ultimately eliminating these gaps are necessary steps for addressing broader development gaps, and hence should be among the key policy ingredients of the development strategies of all developing countries and their development partners.

Government, public sector, and public-private partnerships will play important roles. Although growth will largely have to be driven by a dynamic private sector, there is a crucial role for the government in providing the business-friendly environment and levelling the playing field, especially in instances where the market fails to function efficiently. Government can support private investment and entrepreneurship by eliminating impediments created by market, institutional, or policy failures. This requires the government and public sector to invest in public goods and human capital, build institutional capacity, maintain macroeconomic stability, adopt market-friendly policy, protect property rights,

and maintain rule of law. In setting policy and reform priorities, the government should identify the binding constraints to growth, and target its efforts and resources at relaxing them.<sup>9</sup> Partnerships with the private sector in diversifying the production structure of economies and creating productive jobs should also be part of the policy package. The government should pay attention not only to the pace, but also to the pattern of growth, and make it “broad-based” (Ianchovichina and Lundstrom 2009).

#### IV. CLOSING NONINCOME DEVELOPMENT GAPS

##### A. A Snapshot of Selected Gaps

Nonincome development gaps across and within countries are disturbingly large. Various nonincome development indicators suggest the living standard of developing Asia falls far below that of the OECD and the gaps are substantial in many subregions. In 2008, mortality rates among children under 5 years of age were over six times higher in developing Asia as compared to the OECD—46 per 1,000 children versus a little under 8, respectively (Table 7). However, sub-Saharan Africa suffered from far higher mortality rates (almost 140). Within developing Asia, the highest mortality rates were recorded in Central and West Asia (95) while the lowest were found in East Asia (21) and Southeast Asia (37). Mortality rates in South Asia and the Pacific were in between these extremes (i.e., 63–66).

These wide differences in a key health outcome reflect, among others, differences in the quality of health systems across regions and within countries. One way in which the quality of the health system may be captured is through its ability to immunize young children from deadly and infectious diseases. There are considerable regional differences in immunization rates of children between the ages of 12–23 months. For example, as Table 7 shows, 96% of young children have been vaccinated against diphtheria, pertussis, and tetanus in the OECD. The corresponding immunization rates in developing Asia were more than 10 percentage points lower on average. They were still lower for sub-Saharan Africa.

Another variable that can reflect quality differences in health systems is the number of hospital beds available, adjusted for the size of a country’s population. In 2007, the former Soviet Union provided the largest number of hospital beds, at about 95 per 10,000 people, followed by Eastern Europe (58.4), OECD (53.7), developing Asia (15.3), and sub-Saharan Africa (9.1). Within developing Asia,

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<sup>9</sup>For example, a recent growth diagnostic study on the Philippines by ADB (2007) found that the critical bottlenecks faced by the country in moving toward high and sustained economic growth included (i) tight fiscal space due to weak revenue generation; (ii) inadequate infrastructure, particularly in electricity and transport; (iii) weak investor confidence due to governance concerns, particularly corruption and political instability; and (iv) failure to address market failures responsible for a small and narrow industrial base.

South Asia provided less than seven beds per 10,000 people—the lowest of any subregion (see Table 7)—while East Asia provided 24, fairly similar to the cases of Central and West Asia and the Pacific (21.1 and 22.7, respectively). Southeast Asia provided a significantly lower number of beds (12.8) than East Asia, though this was still well above the South Asian average.

The OECD countries had on average almost 11 years of schooling, while Eastern Europe, former Soviet Union, East Asia, and Latin America and Caribbean were not far behind. Developing Asia's average of 6.8 years of schooling is on the lower side, but well above that of sub-Saharan Africa where countries had on average only 5.2 years of schooling. Repeating a familiar pattern, the average for developing Asia masks considerable regional variation. South Asia's average years of schooling is as low as that of sub-Saharan Africa and as much as 3 years lower than that of East Asia (8.2 years).

To make matters worse, the quality of education is generally lower in lower-income countries than in higher-income countries. While comparisons of the quality of education across countries are not easy to make, especially when large numbers of countries spanning the different regions of the world are concerned, surveys of employers' assessments of the educational systems from which their employees come can provide a useful benchmark. Based on such a survey of employers, it may be seen from Table 7 that while OECD countries score on average 4.6 (out of 7) on a measure of the quality of education, many developing regions scored much lower (3.7 for developing Asia, 3.4 for sub-Saharan Africa, and 3.2 for Latin America and Caribbean).

Within developing Asia, even though South Asia had the lowest average years of schooling, the quality of its educational system was not the poorest. On average, the lowest quality scores are found in the Pacific and in Central and West Asia (2.9 and 3.1 out of 7, respectively). The highest is in Southeast Asia (4.1) with East Asia close behind (3.9).

Significantly, there can also be large nonincome development gaps *within* countries. Differences of educational attainments and access to health facilities across the poor and nonpoor are an important reason. Such differences occur everywhere, but can be exceedingly high in some countries. Gender-based disparities are a second reason. Indeed, in some developing regions, the average years of schooling in the population described in Table 7 can mask significant differences in average years of schooling across males and females. For example, while the average years of schooling for females is slightly *higher* than that for males in Central Asia, the average years of schooling for females tends to be between 1–2 years less than that for males in South Asia and sub-Saharan Africa.

Table 7. **Education and Health**

| Region/<br>Subregion                                  | Health  |  |  | Education   |  |
|---|---|--|--|---|--|
|   | Mortality<br>Rate, under 5<br>(per 1,000<br>population)<br>2008 | DPT<br>Immunization<br>(% of children<br>ages 12–23<br>months)<br>2008 | Hospital<br>Beds<br>(per 10,000<br>population)<br>2008 | Average<br>Years of<br>Schooling <sup>a</sup><br>2010 | Quality of the<br>Education<br>System <sup>b</sup><br>2008 |
| Developing Asia                                       | 46.2  | 83.7   | 15.3   | 6.8   | 3.7  |
| Eastern Europe<br>Former Soviet<br>Union <sup>c</sup> | 14.0  | 90.8   | 58.4   | 10.0  | 3.8  |
| Latin America and<br>Caribbean                        | 13.9  | 96.1   | 94.6   | 9.2   | 3.9  |
| Middle East   | 22.8  | 90.2   | 20.7   | 8.0   | 3.2  |
| North Africa<br>Sub-Saharan<br>Africa                 | 32.1  | 86.9   | 18.0   | 7.7   | 4.0  |
| OECD  | 29.4  | 96.7   | 16.8   | 6.6   | 3.1  |
|   | 139.4   | 71.9   | 9.1  | 5.2   | 3.4  |
|   | 7.6   | 95.7   | 53.7   | 10.9  | 4.6  |
| Within Developing Asia                                |   |  |  |   |  |
| Central and West<br>Asia <sup>d</sup>                 | 94.6  | 80.2   | 21.1   | 6.0   | 3.1  |
| East Asia   | 21.1  | 96.9   | 24.0   | 8.2   | 3.9  |
| Pacific   | 62.7  | 60.2   | 22.7   | 5.7   | 2.9  |
| South Asia  | 65.9  | 70.3   | 6.8  | 5.2   | 3.6  |
| Southeast Asia  | 36.5  | 85.9   | 12.8   | 6.8   | 4.1  |

<sup>a</sup>Refers to number of years per person aged 15 and above.

<sup>b</sup>Ranges from 1 (not well) to 7 (very well).

<sup>c</sup>Former Soviet Union includes Belarus, Moldova, Russian Federation, and Ukraine.

<sup>d</sup>Central and West Asia includes Afghanistan, Armenia, Georgia, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

OECD = Organisation for Economic Co-operation and Development.

Note: Figures are weighted averages, except when pertaining to quality.

Sources: Barro-Lee Educational Attainment Dataset (Barro and Lee 2010a); Global Competitiveness Report 2008–2009 (World Economic Forum 2008); World Health Statistics (WHO 2010); World Development Indicators Online Database (World Bank 2010c).

## B. Investing in Health and Education

Investing in health and education are crucial for closing nonincome development gaps. Yet, simply making such investments may not be enough to ensure that the health and educational/learning outcomes of the poor actually improve.

While the specifics depend on country circumstances, some broad policy lessons may be drawn. First, the public sector's role is indispensable for financing the required investments. While public financing for health and education is often lower (as a proportion of GDP) the lower national income is, there is nevertheless room in some low-income countries for raising the resources available, especially for the poor.

For example, where public finance for education has been skewed toward supporting higher education, equity and efficiency considerations demand a

rebalancing of priorities toward expenditures on basic education. More generally, better targeting and increased spending on services that directly benefit the poor (and the disadvantaged, such as females) can be powerful tools for reducing development gaps. This is because the largest deficiencies in health and education occur at the bottom end of the income distribution. Governments will therefore produce the biggest marginal gains in national averages by better targeting and focusing expenditures on areas the poor are more likely to use (for example, primary health care facilities in rural areas rather than tertiary hospitals in cities, and primary education rather than tertiary education).

Second, while public finance need not imply public provision of services, the reality is that the public sector is dominant. And, unfortunately, evaluation seems to show more instances of ineffective public provision of health and education services. This appears to be partly the result of financial constraints—for example, the World Health Organization (WHO 2003) found health systems to be largely ineffective below a certain amount of expenditure, even after controlling for government-related effects. A failure of government accountability seems to be an important part of the story.

Significantly, both governments and their development partners would do well to consider more innovative delivery mechanisms coupled with rigorous impact evaluations as they design and implement programs for health and education services. Recent mechanisms holding considerable promise include conditional cash transfers, the use of nongovernment organizations in service contracting, and the use of vouchers and contract teachers in delivering basic education services.

Clearly, the success of a particular delivery mechanism in one country does not imply success in others. Local conditions matter a great deal. However, with an experimental mindset and a commitment to rigorous impact evaluation, there is considerable scope for improving the effectiveness of interventions required for closing development gaps.

## **V. THE ROLE OF SOCIAL PROTECTION IN CLOSING INCOME AND NONINCOME DEVELOPMENT GAPS**

Traditionally, social protection has been synonymous with social assistance provided to vulnerable groups with no other means of support, such as victims of natural disasters or civil conflict, victims of health shocks, handicapped people, or the destitute. As such, it has essentially been viewed as a coping mechanism. This rationale remains important. For example, longitudinal studies of rural households clearly show that illness can have a dramatic impact on a household's

poverty status over long periods of time.<sup>10</sup> But social protection entails much more than this. A growing body of evidence indicates that social protection systems serve two additional purposes: (i) they extend capabilities by allowing individuals to take advantage of economic activities, and (ii) they can help improve efficiency in the labor market. In this way, social protection has a role to play in closing income-related development gaps.

### **A. Seizing Economic Opportunities**

By allowing individuals to better manage risks, social protection systems can enable vulnerable individuals to invest in potentially high-return activities. This is particularly important in an increasingly competitive and market-oriented environment where new but often riskier technologies and opportunities are available. Enabling vulnerable households to take advantage of these would not only improve their welfare but also stimulate economic growth through more productive use of assets and higher human capital accumulation.

Vulnerability to income shocks can lead individuals and households to underinvest in risky activities that can maximize productivity or profits. This is most clearly documented in agriculture: faced with uncertainties in weather and technology, households engaged in agriculture resort to suboptimal choices to cope with risk due to limited insurance and lack of access to credit. Some households are forced to make decisions to reduce their income risk by making production or employment decisions designed to smoothen income flows rather than maximize expected profits. On the other hand, households smoothen their consumption to deal with the effects of income shocks, resulting in a suboptimal level of lifetime consumption due to high precautionary savings.

Moreover, risk aversion and vulnerability to income shocks can curtail other kinds of investments with potentially high returns. Vulnerable households tend to highly discount the future, which is likely to negatively affect long-term investment decisions. Households can hesitate to invest in the education of their children, or may pull them out of school, because of economic shocks. This can have a detrimental impact on the economy in the long run because human capital investment decisions at the household level are suboptimal. In addition, these kinds of decisions can lead to an entrapment effect where vulnerability and poverty perpetuate further vulnerability and poverty due to lack of education.

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<sup>10</sup>For example, a study of villages in rural India demonstrates that because of the illness of a key income earner of the household, which occurred for as long as 25 years ago, a household could fall into and remain in both a poverty trap (due to loss in earnings) and a debt trap (resulting from the need to cover treatment expenses, while having to meet the household's consumption needs) (Krishna 2006).

## **B. Labor Market Efficiency**

A related benefit of well-designed social protection systems is that they can enable labor markets to match workers with jobs efficiently, particularly in the formal sector. In many countries, existing mechanisms for coping with risks are provided through firms (e.g., health insurance, disability benefits, pension programs, etc.). In other countries, such as India, regulations that provide job security have allowed the government to avoid providing workers with social protection. In these cases, it is natural to expect workers in the formal sector, as well as the government, to strongly resist layoffs, even if circumstances make them necessary. However, if workers could count on systems of social protection to provide (i) some basic protection from the loss of income and other job-related benefits (such as health insurance), (ii) efficient labor exchanges that increase the speed and quality of matching job seekers with available jobs, and (iii) subsidized retraining programs, it is likely that workers and governments would take a more nuanced view of layoffs and provide firms with greater flexibility in making hard decisions. Likewise, such social protection systems can allow job seekers to have more time in looking and waiting for appropriate work that match their skills, instead of having to accept the first job offer that comes along.

## **VI. THE ROLE OF EXTERNAL TRADE AND FINANCE IN CLOSING DEVELOPMENT GAPS**

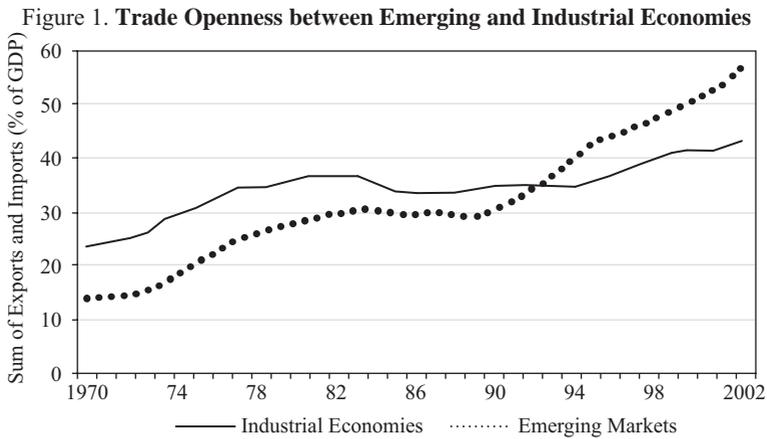
As exemplified by the experience of East Asia in the 1980s and 1990s, international trade, foreign direct investment, and remittances can help a country achieve rapid economic growth and better living standards. Foreign trade expands or complements domestic markets while foreign investment and remittances fill the savings-investment gap. Both, in turn, spur economic growth. Moreover, they bring positive externalities to the domestic economy in the form of technology transfer, economies of scale and scope, and market access that further strengthens the growth process. Market-driven flows can thereby complement and sometimes substitute for official development assistance.

### **A. International Trade**

Trade openness has risen significantly over time in both industrial and emerging economies, but even more so in the latter. Trade openness in emerging markets has grown from 15% to nearly 60% of GDP, bypassing the share in industrial economies in 1994 (Figure 1). Developing Asia's share in world exports has been steadily increasing. Exports from developing Asia rose from 8% of the total in 1980 to over 20% in 2005, overtaking the Euro zone, Japan, and

the US. The strong increase in international trade has helped reduce the development gap between developed and developing countries.

But in closing the development gap, emerging countries face poor financial intermediation and other problems that limit their investments. In recent years, the share of investment has typically been lower than that of savings in developing economies, resulting in a surge of capital flows to rich countries. Developing more efficient methods to channel such flows to poorer countries, where capital is more scarce, and presumably its returns can be higher on average, can help address global development gaps and inequalities.



Source: Bracke et al. (2008, Chart 16), based on *World Economic Outlook* (IMF 2006).

**B. Foreign Direct Investment**

Foreign direct investment has become a significant source of external finance in developing countries, acting as a useful means of integrating countries into the global market, but it fluctuates both in total and across regions (Table 8 and Figure 2).

Table 8. Net Inflows of Foreign Direct Investment (percent of GDP)

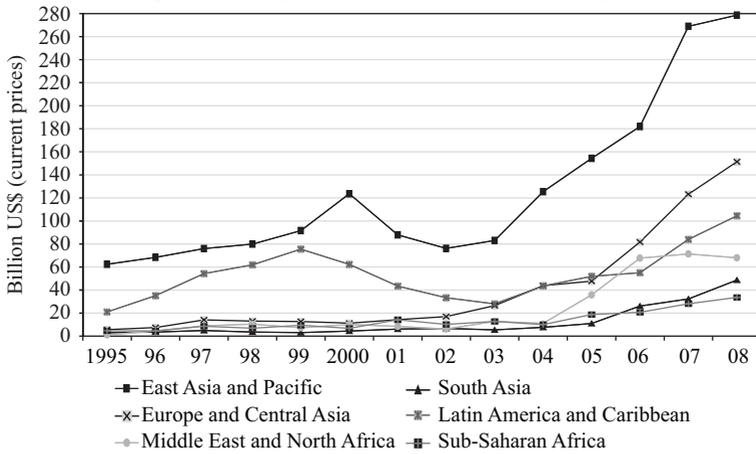
| Region/Subregion                   | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|------------------------------------|------|------|------|------|------|------|------|------|------|------|------|------|------|------|
| Developing Asia                    | 3.49 | 3.41 | 3.69 | 3.77 | 3.97 | 4.96 | 3.48 | 2.83 | 2.67 | 3.49 | 3.80 | 4.06 | 4.74 | 4.30 |
| Europe and Central Asia            | 0.89 | 1.17 | 2.10 | 2.40 | 2.87 | 2.25 | 2.51 | 2.64 | 3.31 | 4.16 | 3.58 | 4.84 | 5.63 | 5.44 |
| Latin America and Caribbean        | 1.44 | 2.25 | 3.25 | 3.75 | 5.56 | 4.28 | 3.21 | 3.00 | 2.35 | 3.05 | 2.87 | 2.52 | 3.20 | 3.35 |
| Middle East and North Africa       | 0.17 | 0.66 | 1.29 | 1.53 | 1.01 | 1.27 | 1.08 | 0.79 | 1.47 | 1.10 | 2.99 | 4.97 | 4.47 | 4.27 |
| Sub-Saharan Africa                 | 1.44 | 1.32 | 2.45 | 2.09 | 2.88 | 2.00 | 4.27 | 2.83 | 2.96 | 1.89 | 2.94 | 2.80 | 3.31 | 3.47 |
| World                              | 1.13 | 1.26 | 1.59 | 2.37 | 3.59 | 4.83 | 2.54 | 2.27 | 1.76 | 1.82 | 2.55 | 3.11 | 4.28 | 3.07 |
| Within Developing Asia             |      |      |      |      |      |      |      |      |      |      |      |      |      |      |
| East Asia and Pacific <sup>a</sup> | 4.47 | 4.28 | 4.59 | 4.80 | 5.09 | 6.27 | 4.23 | 3.35 | 3.27 | 4.29 | 4.63 | 4.59 | 5.48 | 4.54 |
| South Asia                         | 0.62 | 0.69 | 0.91 | 0.65 | 0.53 | 0.72 | 0.99 | 1.03 | 0.71 | 0.86 | 1.08 | 2.26 | 2.24 | 3.31 |

<sup>a</sup> Includes East Asia (but excluding Japan and Republic of Korea), Southeast Asia, and the Pacific.

GDP = gross domestic product.

Source: World Development Indicators Online Database (World Bank 2010c).

Figure 2. Foreign Direct Investment across Regions



Source: World Development Indicators Online Database (World Bank 2010c).

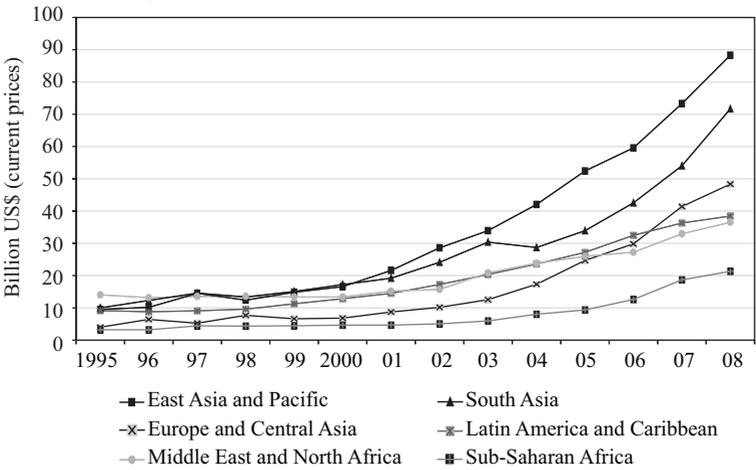
### C. Remittances

International remittance flows complement FDI and other flows while displaying greater stability (Figure 3). Among developing countries, most remittances have been received by middle-income countries,<sup>11</sup> while the share of remittances into low-income countries<sup>12</sup> has been low due to the relatively high cost of migration. In this context, maintaining openness in the labor market may help reduce global imbalances, while supporting development.

<sup>11</sup>Middle-income countries are those in which 2004 gross national income (GNI) per capita was \$826–10,065.

<sup>12</sup>Low-income countries are those in which 2004 GNI per capita was \$825 or less. The following countries are included: Bangladesh; Benin; Bhutan; Burkina Faso; Burundi; Cambodia; Cameroon; Central African Republic; Chad; Comoros; Democratic Republic of Congo; Republic of Congo; Cote d’Ivoire; Eritrea; Ethiopia; Gambia; Ghana; Guinea; Guinea-Bissau; Haiti; India; Kenya; Kyrgyz Republic; Lao People’s Democratic Republic; Lesotho; Liberia; Madagascar; Malawi; Mali; Mauritania; Moldova; Mongolia; Mozambique; Myanmar; Nepal; Nicaragua; Niger; Nigeria; Pakistan; Papua New Guinea; Rwanda; Sao Tome and Principe; Senegal; Sierra Leone; Solomon Islands; Somalia; Sudan; Tajikistan; Tanzania; Togo; Uganda; Uzbekistan; Viet Nam; Republic of Yemen; Zambia; and Zimbabwe.

Figure 3. Receipt of International Remittance Flows



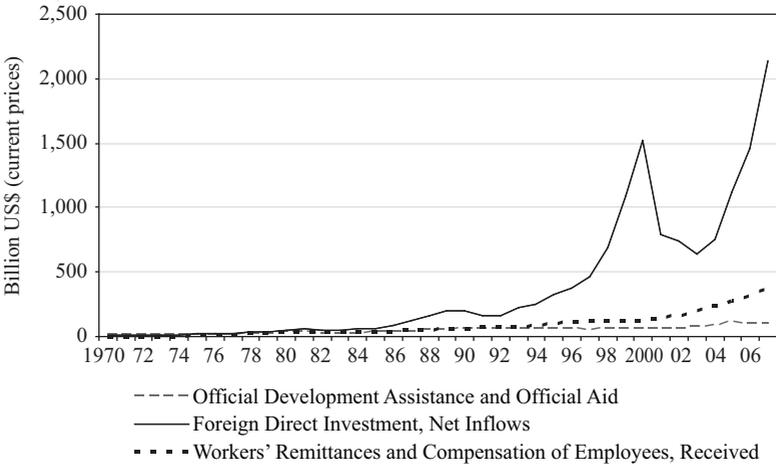
Source: World Development Indicators Online Database (World Bank 2010c).

**D. Role of Development Aid**

The role of official development assistance (ODA) in closing development gaps has been mixed and at times controversial.

Compared to others, aid flows are relatively small (Figure 4). They are also relatively stagnant, except for aid to African countries.

Figure 4. Total Aid, Foreign Direct Investment, and Remittance Flows



Source: World Development Indicators Online Database (World Bank 2010c).

Aid flows generally have specific purposes, but ODA played a positive countercyclical role for developing countries during previous financial crises. After the 1982 Mexican debt crisis, for instance, commercial lending was significantly reduced for about a decade, yet ODA rose slightly to maintain capital flows to Latin America. However, the global economic recession in the early 1990s produced large fiscal deficits in donor countries that led to deep cuts in ODA, which fell from 0.33% of gross national income (GNI) in 1992 to 0.22% in 1997.

More long-term and less volatile development finance is needed to reduce the development gap by investing in infrastructure and social protection. In particular, ADB is strongly supporting the development of efficient and liquid local currency and regional debt markets through the ASEAN+3<sup>13</sup> Asian Bond Markets Initiative (ABMI). The ABMI is important because it will help avert a double mismatch of maturity and currency for Asian borrowers. Without ABMI, debt is commonly short-term and issued in foreign currency, and upon maturity, countries need to come up with foreign currency to repay loans. The ABMI allows countries to issue debts in their local currency, thereby reducing the need to accumulate large foreign reserves. The ABMI will also facilitate the rechanneling of Asian savings effectively and efficiently into Asian investment, providing an alternative financing vehicle for companies or large projects. The ABMI also promotes regional financial harmonization and integration across the ASEAN+3 economies.

It is also important for countries, especially poorer ones, to enhance their access to international capital by improving their macroeconomic performance, investment climate, and use of aid. This is important since the poorest countries have been hit hard by the current crisis. Their exports have dropped 5–10%; private capital flows are to decline nearly 50%; remittances are likely to fall 5–7%; and those depending on tourism for their foreign exchange and jobs will experience a drop in tourism receipts of an estimated 8% (World Bank 2010a).

## VII. CONCLUDING REMARKS

There are significant income and nonincome development gaps around the world. While closing them will require raising economic growth in low-income regions and sustaining it, this paper has shown that these are not enough. Authorities must go beyond policies that simply increase economic growth, to include policies that close nonincome development gaps directly.

To promote high and sustainable economic growth, governments need to support private investment and entrepreneurship by investing in human capital

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<sup>13</sup>ASEAN+3 includes the 10 members of the Association of Southeast Asian Nations (ASEAN), plus the PRC, Japan, and Republic of Korea.

and infrastructure; developing the financial sector; improving governance; and eliminating other impediments created by market, institutional, or policy failures.

To close the nonincome development gaps, attention should be on improving access to and quality of health and education services. This can be achieved by better targeting and increasing public spending on social services that directly benefit the poor, and considering innovative delivery mechanisms informed by rigorous evaluation of their effectiveness.

Significantly, recent policy discussions stress that social protection systems have a vital role to play in closing development gaps, in both income and nonincome dimensions. This is especially so in the context of globalization, where external shocks, competition, and restructuring can raise risks and vulnerabilities to livelihoods.

Developing Asia's experience, as in other regions, has shown that external trade and finance—including FDI, remittances, and aid—play a critical role in closing development gaps. Growth in recent years in South–South trade and FDI flows, especially those originating from developing Asia, highlight an important avenue for mutual benefit between and within developing regions. This reemphasizes the imperative of continuing efforts to promote globalization and regional integration.

As the world transits from the crisis to the postcrisis period, the global community needs to address the development issues raised above. Thus the development agenda for the global community must include the following elements.

- (i) Reducing poverty through higher and more inclusive growth.
- (ii) Substantially increasing investment in human capital and infrastructure, including science and technology investment to boost productivity and reduce negative environmental impacts.
- (iii) Diversifying the structure of economies by moving toward promoting activities where value added is greater and productivity growth faster.
- (iv) Creating an environment for growth and development by strengthening governance, economic management, and conflict resolution.
- (v) Maintaining open trade and stable long-term financial flows by strengthening regional and global cooperation.

This paper focused largely on the requirements for inclusive growth. Apart from being inclusive, however, the development agenda must ensure that growth in the postcrisis world is balanced and sustainable. While these two latter topics are not thoroughly discussed here, the publication on *Rebalancing for Sustainable Growth: Asia's Postcrisis Challenge* (ADB-ADBI forthcoming) addresses these issues comprehensively.

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