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Follow-up to the Millennium Summit and preparations for the high-level plenary meeting of the General Assembly on the Millennium Development Goals: New development paths*

Reconnecting the Millennium Development Goals to the development agenda: an UNCTAD perspective

Note by the UNCTAD secretariat

Executive summary

The MDGs have succeeded in including measures of poverty and human development – such as ill-health, undernutrition and illiteracy – on the international cooperation agenda and in making a strong case for increased development assistance. However, the accompanying policy approach has been framed in terms of human deprivation, leaving the development challenge to be fashioned by more conventional economic thinking. The fundamental problem with this division of labour is not so much the lack of economic goals in the MDG framework, as the lack of a more inclusive strategy of economic development that could integrate and support its human-development ambitions.

The international community has been here before. At the end of the 1970s, Raúl Prebisch was concerned that the newfound "enthusiasm" to eradicate poverty was avoiding long-standing development challenges. He said:

"Who could refuse to fight against poverty? But is this possible, outside the context of development and an enlightened international cooperation policy? Poverty, we are told, is mainly rooted in agriculture, and the productivity of that sector must be increased. Quite so. However, increased productivity produces redundancy in the labour force, and the surplus labour must be employed in industry and other activities. The expansion of industry requires exports, and this is one of the major external obstacles which, far from having been

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eliminated, is becoming worse. And the greatest of the internal obstacles is capital accumulation (both physical capital and human skills), which requires a vast effort on the part of developing countries themselves, in addition to international financial cooperation."

This paper argues that national development strategies, geared to achieving broad-based and accelerated economic diversification, job creation, and technological upgrading, are a necessary foundation for rapid advances in human development, including the MDGs – advances which are needed to reinforce and sustain inclusive economic growth.

Introduction

This paper argues that national development strategies, geared to achieving broad-based and accelerated economic diversification, job creation, and technological upgrading, are a necessary foundation for rapid advances in human development, including the MDGs – advances which are needed to reinforce and sustain inclusive economic growth. The establishment of such virtuous circles is not the automatic outcome of market forces, but requires strategic policies and stronger government regulations. In particular, there will have to be a renewed emphasis on: (a) a growth- and development-oriented macroeconomic framework which moves beyond the recent fixation with short-term price and output stability and focuses more firmly on productive investment, including in the public sector; (b) domestic resource mobilization, and raising public revenue in particular, as the surest basis on which to finance development expenditures; (c) an integrated treatment of economic and social policies; and (d) reform of the international governance architecture to build greater coherence across trade, financial and technology flows in support of inclusive development.

I. Development in the time of global finance

The turn to policy conformity

1. After 1945, economic thinking promoted the view that development hinged on establishing a virtuous circle driven by external economies, with a key role played by capital accumulation and technological innovation. A mixture of institutional arrangements (the public and private sectors, large and small enterprises, open and protected markets etc.) and a variety of policy instruments (from trade liberalization to nationalization) appeared best suited to raising domestic resources and channelling these into productive investments. The resulting search for positive feedback mechanisms that could strengthen resource mobilization and support the diversification of economic activity produced an extensive body of policy-driven analysis which took account not only of local conditions and constraints but also of the gaps, biases and asymmetries in international economic relations.

2. In response to the debt and development crisis of the early 1980s, a set of standard policy measures – collectively known as the Washington Consensus – was promoted, which aimed at quickly removing structural impediments and institutional impediments on market forces and restoring macroeconomic stability. The potential gains from removing market distortions were ubiquitous, but because these were believed to be greatest in developing countries, the gains from the rapid adoption of these policies would be inversely proportional to income levels, leading to a narrowing of economic and social gaps and a levelling of the global playing field.

3. This convergence logic was closely associated with international trade dynamics. However, the increasing role of financial motives, markets and institutions in the operation of domestic and international economies – “financialization” – has been the big trend of the recent globalization era. There have been massive two-way flows of funds dominated by short-term capital movements in the form of cross-border bank lending, equities and bonds. Capital mobility accelerated with the collapse of the Bretton Woods system of fixed exchange rates and the dismantling of capital controls in developed countries. Financial openness was expected to liberate countries from their own savings constraints, inter alia increasing the availability of credit to local consumers and enterprises, improving the mobilization and intermediation of domestic savings, and generally spurring investment and making it more efficient.[1]

4. Even more than with the liberalization of trade, the freeing of finance carried a strong demand for institutional and policy conformity. Despite some disagreement about how rapidly financial markets should be liberalized, the basic choice presented to all countries, regardless of their level of development, was, according to Michael Camdessus, head of the International Monetary Fund (IMF), clear-cut: “…either to integrate themselves into the international economy or to become marginalized from it and thus fall farther and farther behind in terms of growth and development”; doing so implied deregulating financial markets and rapidly opening their capital accounts.

5. The new strategy claimed some early success in bringing inflation under control, recovering a reasonable degree of macroeconomic stability, and facilitating re-entry into international capital markets. However, the record in terms of growth, jobs and poverty reduction was disappointing. A number of countries that had avoided the debt crisis, particularly in East Asia, did continue on a strong growth path, albeit by adopting their own brand of creative and heterodox policy measures. By contrast, the anticipated African economic renaissance, following the lost development decade of the 1980s, failed to materialize; the shock therapy applied in transition economies proved deeply destructive in both economic and social terms; and the growth recovery in Latin America was tentative and uneven. The Asian financial crisis also served as a reminder that even countries with a strong economic record could become vulnerable to damaging external shocks if they opened up too quickly to the international economy.

6. There is very little evidence to suggest that the package of adjustment policies has been able to consistently generate the rates of growth needed by poorer countries to tackle their development deficits. The World Bank’s own assessment of the available studies is telling: “Together with analysis of individual country experiences and over-optimistic forecasts by international financial organizations and private entities, these studies give an empirical base to perceptions that the economic policy reforms of the 1990s yielded results below expectations.”

New goals, old policies

7. The sense of unmet expectations was already apparent at the Social Summit in Copenhagen in 1995, when poverty was placed at the top of the agenda. The 1996 United Nations Development Programme (UNDP) Human Development Report called for a new approach to linking growth and human development. In a seminal report a year later entitled “Shaping the twenty-first century: the contribution of development cooperation”, the OECD made a strong pitch to refashion development cooperation in terms of poverty and human development as a direct response to growing aid fatigue in the donor community. It argued for a new partnership approach

[1] Although the principles of international factor movements do not differ in their essentials from those underlying international trade, not all proponents of rapid trade liberalization support the argument for financial liberalization.

to development assistance, in which donors harmonized and aligned their support behind the national strategies of recipient countries and extended that support from technical assistance to policy measures in the areas of trade, debt, private capital flows and technology.[2] In 1996, the international financial institutions (IFIs) launched the Heavily Indebted Poor Countries (HIPC) initiative, which was soon linked to Poverty Reduction Strategy Papers (PRSPs) and became a precondition for access to the Fund's Poverty Reduction and Growth Facility and a precondition for access to the Poverty Reduction Support Credit introduced by the World Bank in 2001.

8. The Millennium Summit consolidated this focus, and helped extend it to bilateral development agencies and initiatives. In the wake of the Summit, aid picked up, the development agenda was extended, and more attention was given to the provision of social safety nets. The Summit also highlighted systemic problems in the way that globalization had evolved, acknowledging the special difficulties facing developing and transition economies and calling for global policies and measures to tackle the unfairly distributed costs and the unevenly shared benefits of globalization. Unfortunately, these problems have largely been neglected in subsequent discussions, and the politics of poverty reduction have, instead, focused on "governance" at the national level as the key to achieving fairer outcomes.

9. Good governance has been defined by the World Bank as "the institutional capability of public organizations to provide the public and other goods demanded by a country's citizens or their representatives in an effective, transparent, impartial and accountable manner". In practice, this has translated into an emphasis on anti-corruption measures and weaker business regulations, and linked to governance conditionalities attached to multilateral loans and aid flows. But while it is understandable why such measures are considered necessary, it is less clear why the focus is only on the political realm, ignoring the considerable concentration of economic power that has accompanied the rise of deregulated markets. Doing so not only runs the risk of the ignoring the economic distortions arising from corporate power, but also of deflecting attention from the inconsistencies and failures with existing macroeconomic and structural adjustment policies, as a result reinforcing the idea that rapid liberalization and close integration into the global economy continues to hold the key to fast and sustained growth.

Mixed results

10. Despite the MDGs drawing attention to the role of policies and institutions in tackling poverty and social deficits, the picture, as sketched in the Secretary-General's background note to the High-level Event in September continues to be a mixed one. Although the world, as a whole, has made reasonable progress in reducing levels of absolute poverty, many countries are not on track to halve extreme poverty by 2015. Moreover, China, and to some extent, India, as well as regions such as East and South-East Asia, where the majority of the world's poor are still located, account for most of that progress, thanks to strong growth during the last decade or so. Indeed, the absolute number of poor people has gone up in several countries in sub-Saharan Africa, in South and Central Asia, and in the Middle East and North Africa (table 1).

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[2] The report also included a list of seven International Development Targets, devised in consultation with the UNDP Human Development Report Office, which were recommended as the appropriate focus of the new approach to development cooperation. The MDGs built on the OECD list, but multiplied the targets, by drawing selectively on the outcomes of major international conferences in the 1990s, and also added an eighth, rather weakly specified goal, namely "Developing a Global Partnership for Development".

Table 1. Regional trends in extreme poverty, 1990–2005

	East Asia and the Pacific	Eastern Europe and Central Asia	Latin America and Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa
	Percentage living on less than $1.25 per day					
2005	16.8	3.7	8.2	3.6	40.3	50.9
1999	35.3	5.1	10.9	4.2	44.1	58.4
1990	54.7	2.0	11.3	4.3	51.7	57.6
2015 target	27.4	1.0	5.7	2.2	25.9	28.8
Change to meet target	Reached	-2.7	-2.6	-1.4	-14.5	-22.1
	Number of people living on less than $1.25 per day (millions)					
2005	316	16	44	11	596	388
1999	635	22	55	12	589	383
1990	873	9	49	10	579	298

Source: UNDESA.

11. Perhaps more telling still in terms of a forward-looking agenda, an examination of the links between economic growth and human development over the five decades since 1960 points to the difficulties, albeit with regional variations, in re-establishing virtuous circles. This was particularly true in the 1980s and 1990s. Their re-emergence in Latin America during the past decade is an encouraging sign, albeit one associated with a break from conventional policy advice. But despite the favourable global macroeconomic conditions, there are fewer signs that such virtuous circles were triggered across Africa, even as growth picked up.

Table 2. Growth and human development cycles since the 1960s (number of observations)

	1960s	1970s	1980s	1990s	00s
Virtuous	28	21	8	6	26
Vicious	18	31	42	38	12
Economic growth lopsided	14	12	2	2	11
Human development lopsided	8	10	29	35	15

Source: UNCTAD.

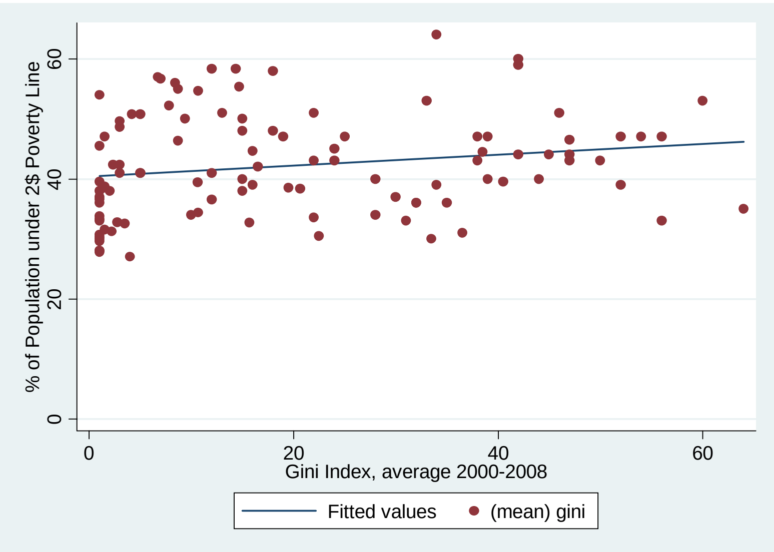
Note: For the classification of cycles, the under-five mortality rate is used as the measure of human development, and per capita real income growth is used as the measure of growth. Country experiences are divided into virtuous, vicious, human development–lopsided and economic growth–lopsided, according to whether performance is above or below the average of these measures, where the averages are those of the total sample of developing countries, weighted by population. The final column refers to the period 2000–2008 and thereby ignores the consequences of the economic downturn.

12. The dangers of debt-fuelled growth have, since the financial collapse of 2008, come under much closer scrutiny. UNCTAD has persistently warned that the domestic and global imbalances that accompanied that growth carried very serious downside risks. Financial bubbles almost always give rise to lopsided expansions in some sectors which become unviable with a return to normal conditions. This is particularly true for areas susceptible to speculative investment, such as residential

and commercial property, although more productive sectors can also experience such a phenomenon, as was the case in South-East Asia in the run-up to the crisis in 1997. Furthermore, with increased access by households to credit, financial booms can also produce sharp increases in consumer spending, reducing household savings and raising indebtedness, as happened in Latin America during the 1990s.[3]

13. The rapid deregulation of financial markets has been accompanied almost everywhere by an increase in inequality. This trend offers a likely explanation of why strong growth and weak human development coexisted in many developing countries during the recent cycle. A consistent picture that emerges from the last decade is the very strong correlation between high levels of inequality and limited progress (or even regression) on the MDGs. Figure 1 plots the average Gini index over the period 2000–2008 against the average headcount poverty rate for the same time interval;[4] it suggests a weak but positive association between inequality and the share of population earning less than $2 per day. The picture is enriched once we try to assess directly the impact of inequality on the mapping between growth and human development.

Figure 1

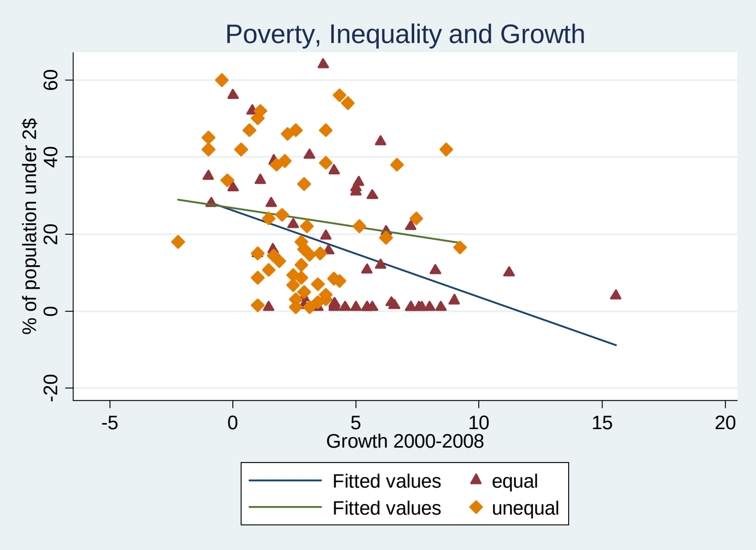


14. Figure 2 shows the differential impact of growth on poverty once we split our sample between equal and unequal countries. Those countries with a relatively low inequality (e.g. a Gini index below the sample average) display a much stronger correlation between growth and poverty reduction vis-à-vis the unequal economies for which the impact of growth is close to zero.

[3] The volatility and procyclical nature of private capital flows to developing countries explain in part why no evidence can be found indicating that such capital movements in general have resulted in increased investment or higher long-term economic growth during the past three decades.

[4] The data for figures 1–5 are taken from *World Development Indicators 2009* and cover 100 developing countries for the period 2000–2008.

Figure 2



15. The emergence of growth winners and losers becomes even clearer when we consider other measures of human development. In figure 3 we investigate the differential impact of growth on the under-five mortality rate (MDG-4), while figure 4 considers the primary school enrolment rate (MDG-2). While the association with growth is positive for the more equal countries, it turns negative when we look at unequal societies. Economic growth, in other words, seems to worsen the living conditions of vulnerable people where the distribution of income is unequal.

Figure 3

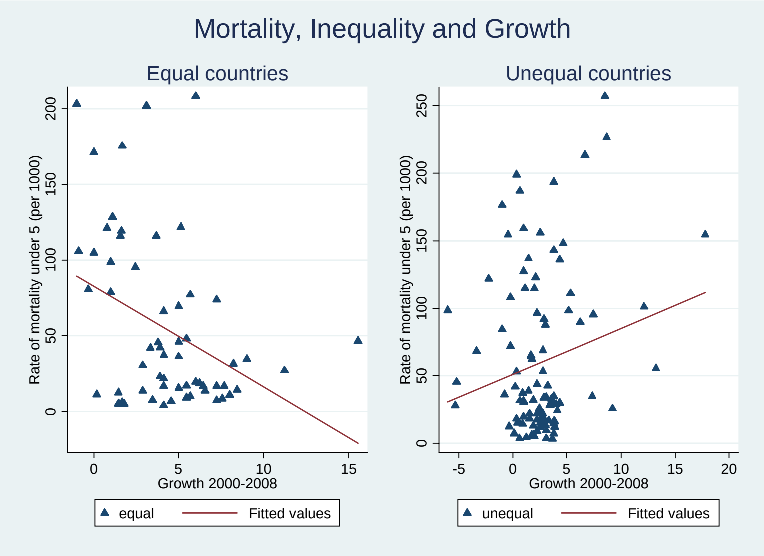
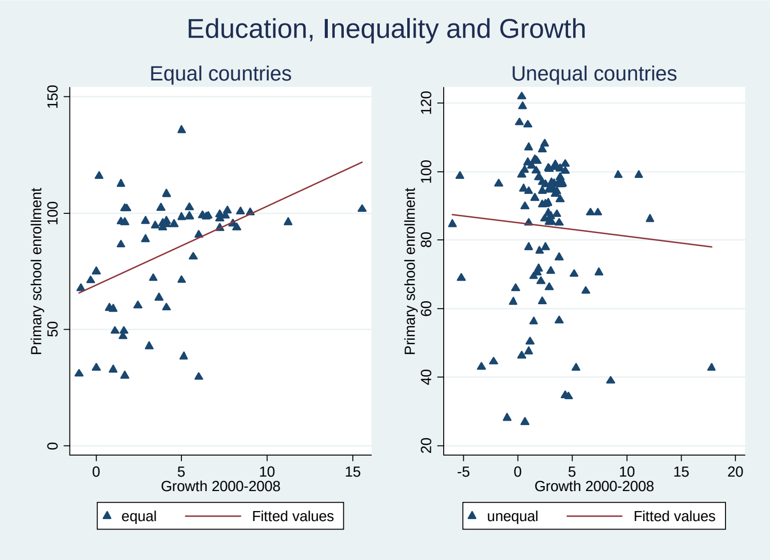


Figure 4



16. Just as importantly as the growing inequality trend, inconsistencies and failures in the conventional policy wisdom also help to explain why the virtuous circles between growth and human development needed to meet the MDGs have been difficult to trigger in recent years:

(a) Prioritizing price stability, restrictive budgetary policies and monetary restraint, even in regions where inflationary pressure does not seem to have been a persistent problem, has worked against capital accumulation in both the public and private sectors.

(b) Rapid trade and financial liberalization which coexisted with growing macroeconomic imbalances has required tight monetary policy and high interest rates: this combination has worked against long-term investment, particularly in the public sector, which is essential for tackling social deficits, particularly where fiscal revenues from trade taxes have been falling.

(c) Premature financial liberalization has led to sharp swings in asset prices, exchange rates and aggregate demand, causing a fundamental uncertainty regarding the return on capital, shortening planning horizons, and promoting defensive and speculative strategies in investment which can, in turn, exert a significant adverse influence on the pace and pattern of capital accumulation, economic growth and employment.

(d) The further weakening of regulation, common to most developing countries, has meant that surges in capital flows have exacerbated the tendency towards excessive risk-taking and created the conditions for boom and bust cycles; at the same time, the procyclical nature of private capital flows has limited the space available to governments in developing countries to conduct countercyclical macroeconomic policies.

(e) Boom and bust cycles associated with rapid entry and exit of capital under open capital account regimes have tended to add to the poverty challenge, not only by directly destroying jobs in the formal sector during crisis episodes, but also by failing to build up a more resilient capital stock during the boom years.

(f) Rapid trade and financial liberalization undertaken with the expectation that this would shift resources into more competitive sectors and help raise productivity growth has often led to premature deindustrialization, growing unemployment and rising wage inequality. This has also tightened the balance of payments constraint on accumulation and growth, thanks to unfavourable movements in the terms of trade.

(g) Even where more favourable trading conditions have prevailed, the accumulation of reserves as an insurance against future shocks has diverted resources away from productive investments that could have helped address poverty and social deficits; that problem has been intensified where reserve accumulation has depended on borrowing the funds on international capital markets.

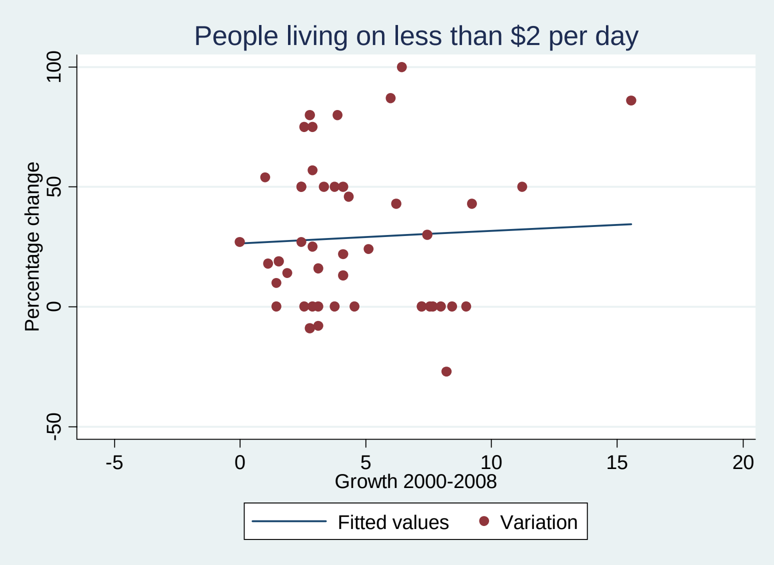
17. The inclusion of poverty and social goals signalled the need for a significant scaling-up of resources to finance new investments in economic and social infrastructure to accelerate progress on poverty reduction and human development. However, that agenda soon ran up against the stability-focused macroeconomic policies that dominated policymaking in the period before the global financial crisis. What is now urgently needed is a more inclusive development framework which can not only deliver faster and more sustainable economic growth, but can establish a more virtuous link between that growth and human development.

II. Reviving virtuous development circles

18. A basic lesson to be drawn from successful development experiences is that sustained poverty reduction depends on a fast pace of growth. The failure of the economic policy agenda of the past three decades to deliver sustained catch-up growth provides an immediate justification for a new approach to development strategies. However, the connection between growth and poverty is not an automatic one. Some fast-growing economies have failed to tackle poverty, while some slower-growing economies have had a more successful record in this area (fig. 5). Making growth more inclusive requires that employment and income distribution – downplayed in the conventional policy advice of recent years – be given an equal footing with price stability in the design of more inclusive development strategies.

19. A new framework will also break with the deprivation focus which has guided much of the MDG agenda. The policies needed to strengthen the links among growth, distribution and employment are unlikely to emerge from an undue focus on levels of abject poverty. In this respect, the one or two dollar-a-day benchmark may not provide the best guide to policymakers for addressing the structural vulnerabilities that determine whether or not growth translates into poverty reduction or improving human welfare.

Figure 5



Investment matters

20. In the complex interplay of linkages that make up a virtuous growth regime, capital accumulation holds a central place. Investment simultaneously generates income and expands productive capacity. Moreover, technological progress and skills acquisition are all likely to require investment. Due to the sensitivity of the investment decision to the level and stability of economic activity, investment also plays an important bridging role between the cyclical and longer-term features of economic development.

21. A given pace of capital accumulation can, of course, generate different growth rates, depending on its nature and composition, as well as the efficiency with which production capacity is utilized. This is one of the main reasons why econometric studies on the determinants of growth have failed to establish a one-to-one relation between the rate of investment and economic growth. Still, it is generally agreed that growth cannot be sustained without an adequate level of investment.

22. While economists continue to debate the determinants of investment, in any discussion of the forces governing the process of capital accumulation, the manner in which the richest stratum of society – the class of domestic entrepreneurs – acquires and uses its income plays a key role. A good deal of evidence suggests that after the initial stages of industrialization, when agricultural incomes provide the main source of investment, capital accumulation is financed primarily by profits in the form of corporate retentions, rather than household savings which grow in importance with rising incomes.

23. Successful governments have strengthened the links between profits and investment as part of their development strategy. This can be made consistent with inclusive development to the extent that the resulting investments create jobs and underpin rising wages. In a sense, productive investments on a sufficient scale can act like a tax on profits, restricting their use for personal consumption by local elites. As such, channelling scarce resources to the private sector can provide a social as well as an economic justification for the concentration of an important part of national income as profits in the hands of a small minority of the population.

24. The early East Asian experience exemplifies these virtuous linkages, with a rapid expansion in the industrial workforce and a drop in agricultural employment as investment and growth accelerated, and with rising wages lagging shortly behind rapid productivity growth. However, this has not been replicated in some of the more recent fast-growing Asian economies (Cambodia, China, India and Viet Nam), either because inequality worsened and/or the employment intensity of growth was weak. The declines in poverty were, as a consequence, lower than might have been expected given their headline growth figure, and in one case – Cambodia – poverty actually increased. In the case of China, after 1995, the rate of poverty reduction decelerated, as growth became more urban-centred and inequality increased.[5]

25. Even as resources are being channelled into productive investments, a variety of complementary measures aimed at redistributing assets and incomes can help to reinforce growth by encouraging higher productivity in smallholder agriculture, taxing luxury consumption, increasing human capital investments, creating larger domestic markets to realize scale economies, and building greater resilience to external shocks and greater political stability. The desirable combination of growth-enhancing and distributional measures is likely to vary across countries and over time. According to one study of a group of 50 developing countries, in a large number of mainly middle-income developing and transition countries, redistribution had been more effective than growth in eliminating poverty; in others, a mixture of redistribution and growth had been the most effective; and in another group of mainly very poor countries, fast growth alone had been the most effective mechanism.

The challenge of domestic resource mobilization

26. In addition to establishing domestic enterprises, success in mobilizing domestic resources for productive investment is determined, to a significant extent, by the level of income per capita and by economic growth. As economic growth increases and incomes rise, savings will also rise, and state revenues should rise as a ratio to gross domestic product (GDP) as a larger share of the population pays taxes or as current taxpayers receive more taxable income.

27. The challenge of domestic resource mobilization in predominantly agricultural economies presents specific policy challenges. There are no quick or general solutions, but an effective set of price and fiscal incentives must be in place to give farmers – particularly small-scale producers – a predictable financial surplus and to encourage them to invest some of it to raise productivity and diversify output. Specific measures to strengthen productivity and extend markets can be greatly enhanced by basic infrastructure investment.

28. The institutional capacity needed to start raising the rate of capital formation is probably not that great. However, the premature abolition of state institutions, such as marketing boards and development banks, has been unhelpful in many cases. Measures to fill this gap will require restoring some of these functions to state institutions, strengthening others, as well as, more generally, restoring a degree of professional integrity and respectability to public offices, both of which have been lost under adjustment programmes.

29. Reforms in the primary sector which succeed in raising productivity, improving the fiscal base and generating additional export revenues will have a positive impact on resource mobilization in other sectors of the economy. However, these reforms

[5] The rising levels of inequality in China have been documented in a series of recent studies by the Chinese Academy of Social Sciences. In response, President Hu Jintao has stressed the importance of “harmonious growth”.

will almost certainly be accompanied by a significant shedding of labour as farm size and the technological intensity of production increase. The challenge of absorbing surplus labour from the agricultural sector will have to be met by expanding labour-intensive activities elsewhere in the economy.

30. Public investment to provide energy, transportation, water and sewerage services etc. to the growing urban population has played a key role in reducing poverty as dynamic economies have made the transition away from being predominantly rural economies. It has also helped crowd in private investment into low-skilled manufacturing activities and related services. However, the later the industrialization process begins, the more capital-intensive it tends to become. This can place additional pressures on policymakers to support domestic resource mobilization and to make sure that investment brings significant social returns, including through the creation of sufficient jobs in the formal sector.

31. Opportunities for some late industrializers to become “workshop economies”, producing large quantities of labour-intensive products for export, can go some way towards sufficient jobs being created in the formal sector. Indeed, successful industrialization and progress in poverty reduction in developing countries is often based on mutually reinforcing dynamic interactions between capital accumulation and exports. Exports broaden the size of the market and thus allow scale economies to be exploited; they also provide the foreign exchange needed for capital accumulation, in view of the dependence of most developing countries on imported capital goods. At the same time, investment improves export potential by adding to production capacity and improving competitiveness through productivity growth. Such a process is typically characterized by rising investment, exports and manufacturing value added, both in absolute terms and as a share of GDP. Over time, both foreign exchange and savings gaps close, as exports and domestic savings begin to grow faster than investment.

32. A number of policy lessons drawn from successful industrializers remain central to efforts to build more virtuous circles of inclusive development:

(a) A pro-growth macroeconomic stance is essential, involving a full range of macroeconomic instruments both to stimulate investment and to counteract any damaging effect on capital formation from economic shocks and volatility, including capital controls calibrated to specific conditions to allow countries to meet their objectives for employment, price stability and external balance. Other instruments, including debt restructuring, wage and price controls, and labour-market policies, are also be needed to help maintain growth at the desired rate.

(b) A range of more selective measures can help increase domestic resource mobilization, for example: selective import protection; controls over interest rates and the allocation of credit; managed competition involving government encouragement of specific mergers, and restrictions on entry into certain sectors; the screening of imported technology; and the promotion of cartels for particular purposes, such as product standards or export promotion.

(c) From an early stage, fiscal and other incentives will have a role to play in encouraging the growth of more sophisticated industries. Additional measures will also be needed to encourage the creation and expansion of technological capacities, such as local research and development facilities, the expansion of educational institutions, and a wide range of vocational training.

(d) Industrial policy needs to be linked to labour-market policy at an early stage, in order to ensure that structural change proceeds as smoothly and as fairly as possible. The record of active labour-market policies is mixed, but there is an array of measures that combine transfer payments with work programmes and training that can be used to improve the effectiveness of labour markets.

(e) Adopting a more strategic approach does not mean favouring universal protection, as is sometimes suggested; rather, it prescribes liberalization, protection and subsidies in various combinations and on a selective basis, depending on a country's resource endowments, macroeconomic circumstances and level of industrialization. This will likely need a sharpening of the political skills of policymakers and trade negotiators in support of more development-sensitive trade agendas.

A first look at policy space

33. There are real concerns among policymakers in developing countries that, regardless of earlier successes, pursuing similar development strategies is no longer feasible given the constraints of a new international economic order. Diminished sources of official financing and greater reliance on private capital flows are one source of potential constraint on policy options, particularly where financial and macroeconomic objectives are involved. Another is the new obligations under the World Trade Organization (WTO), which subject domestic policies – particularly in the areas of industrial and technological development – to much stricter disciplines in the multilateral trading apparatus. Finally, conditionalities attached to multilateral loans have brought an ever-widening set of policy measures under the close surveillance and assessment of the multilateral financial institutions. All these potential constraints need to be re-examined, with an eye to ensuring that developing countries have sufficient policy space to create an investment–export nexus that can support rapid and sustained growth.

34. Reclaiming policy space from the stranglehold of finance is a basic challenge in many middle-income developing countries, where high and volatile interest rates and overvalued exchange rates have damaged investment prospects, particularly in the traded-goods sectors. An independent central bank is no panacea, and runs the danger of imparting an unhelpful deflationary bias to macroeconomic policy.

35. The major obstacle to establishing a more dynamic investment–export nexus, however, is the instability of private financial flows motivated by the prospect of arbitrage and speculative gains. Certainly, a key element in any development strategy designed to enable a country to benefit from gradual integration into the global trading system is successful management of the exchange rate. The objective is to sustain a rate that will support competitiveness over the longer term and to retain enough policy autonomy to make orderly adjustments in the face of external shocks. Controls on capital flows therefore need to become a legitimate feature of the policymaker's toolkit. The techniques are well known, and range from market-based measures – intervention in the foreign exchange market, more flexible exchange rate bands, non-interest-bearing reserve requirements on foreign liabilities, or taxes to reduce the international arbitrage margin – to direct controls on, for example, banks' net external positions, on borrowing abroad by non-banks, or on foreign equity participation in domestic firms.

36. That said, many developing countries are still not using all the policy options open to them. Many of the financial, fiscal and macroeconomic policies that can help to create the basic conditions for faster and better-directed capital accumulation and to channel investments consistent with broader development objectives are not governed by multilateral agreements. The scope for industrial policy, though reduced with respect to export promotion, still allows for various forms of direct and indirect support; and various forms of protection and other support – especially temporary – are still allowed in the case of infant industries.

III. Debt, public investment and the Millennium Development Goals

37. The previous section has suggested that a more inclusive development path will require large public investments in human and physical infrastructure. Such investments have the potential not only to add directly to income and employment, but also to act to crowd in private investment, thereby helping to accelerate and sustain growth at rates needed for eradicating extreme poverty and hunger, as called for by MDG-1. Achieving the MDGs also necessitates increased public spending on health and education. This, too, can make important contributions to long-term growth, in addition to its direct impact on human development through progress in several MDGs.

38. The role of public investment in achieving the MDGs is likely to vary depending on local needs and economic conditions, and a country-by-country assessment of that role will be essential. A number of commentators have linked a big public investment push to meet the MDGs to the call for the international community to meet the 0.7 per cent official development assistance (ODA) target. This is particularly important for the least developed countries (LDCs), where ODA can count for a large percentage of government expenditure, but even so, ODA is only likely to be effective if this also helps to mobilize domestic resources.

39. In many countries, however, public finances are not in the shape needed for these tasks to be carried out effectively. During the 1980s and 1990s, the single most important objective of fiscal policy was to reduce budget deficits from the very high levels reached as a result of economic contraction and increased interest payments, and to check monetary expansion and bring inflation under control. These fiscal and monetary objectives had, in many cases, been attained by the end of the 1990s, albeit accompanied by a rapid build-up of public debt, notably domestic debt. This, in turn, forced policymakers to shift their attention from deficit reduction and price stabilization to the generation of primary budget surpluses and debt stabilization.

40. The brunt of the cuts in primary spending fell on public investment. At the end of the 1970s, public investment in developing countries taken together was around 10 per cent of GDP and in some countries it was even greater than private investment. By 2005, despite the adoption of the Millennium Declaration and the shift in the global dialogue towards poverty reduction, that figure had dropped to just above 5 per cent of GDP for lower-income developing countries and for upper-middle-income countries. The drop between 1980 and 2005 was steeper still, from over 10 per cent of GDP to almost 4 per cent.

41. In Latin America, the decline that started with the debt crisis in the 1980s continued throughout the 1990s and public investment as a proportion of GDP fell even below the levels of some industrial countries with much better human and physical infrastructure. In several heavily indebted emerging-market economies, interest payments as a proportion of GDP have been close to or above public investment (table 3).

Table 3. Public investment and interest payments, 1995–2008
(as a percentage of GDP)

	Public investment	Interest payments
Argentina	2.4	2.6
Bangladesh	6.6	1.7
Brazil	1.9	6.7
Colombia	6.9	3.5
Egypt	4.4	5.2
El Salvador	2.9	1.7
Ethiopia	8.7	1.4
Ghana	10.0	5.1
Kenya	4.5	3.4
Lebanon	4.3	13.7
Mexico	3.8	4.2
Morocco	2.9	4.1
Pakistan	3.1	4.3
Philippines	3.6	5
South Africa	2.7	3.6
Turkey	3.8	12

Source: UNCTAD database.

42. The persistent retrenchment of public investment opened a sizeable infrastructure gap, since the private sector did not step in and invest as much as expected, despite increased emphasis, particularly from some donor countries, on the role of private–public partnerships. Even in middle-income countries, annual investment rates of over 5 per cent of GDP in infrastructure would be needed in order to meet the MDGs, and the task becomes even more challenging if account is taken of the financing needs in other areas affecting the MDGs, such as health and education. Despite the recovery in public investment in a number of countries during the economic upswing after 2002, this figure is still above the recent levels of investment in infrastructure, and even exceeds the entire public investment in many of these countries. Moreover, the global downturn is likely to very quickly reverse the recent gains.

43. Not only do interest payments on public debt absorb a large proportion of government revenues that could be allocated to the MDGs, they have also become a major source of increased inequality in income distribution. Unlike external debt servicing, government revenues used for interest payments on domestic debt do not constitute a net transfer from the private sector, but entail intra–private sector redistribution depending on the incidence of the tax burden and the distribution of public debt holdings.

44. The tax system in many developing countries has become more regressive, with increased financial liberalization and capital mobility, which have effectively reduced the ability of governments to tax capital and financial incomes. In raising revenues in order to meet increased debt servicing and stabilize the public debt ratio, the emphasis has been on indirect taxes, notably value-added and consumption taxes, rather than on income and property taxes. In the case of many LDCs, where tariffs

and other taxes on trade provide an important source of revenues, rapid trade liberalization has put additional pressure on indirect taxation to fill the revenue gap.

45. Government spending can offset the adverse distributional impact of such taxes through allocations favouring the poor and underprivileged. However, this is increasingly difficult with the increased allocation of government revenues to interest payments and the growing importance of domestic debt.

46. There is a growing consensus that developing countries need greater "fiscal space for growth." For the IFIs, fiscal space is defined as what is left after servicing debt; it "…refers to a government's ability to undertake spending without impairing its solvency, that is, without impairing its present and future ability to service its debt… Fiscal space is therefore the gap between the current level of expenditure and the maximum level of expenditures that a government can undertake without impairing its solvency."[6]

47. Even if it is politically feasible, expanding fiscal space through efficiency gains or higher taxes, as proposed by IFIs, may not always be development-friendly; excessive taxation can hurt investment and growth, while efficiency is not always the norm that should govern allocation of public spending. Moreover, it is essential to make a sound judgement on the extent to which these can be relied on for attaining the MDGs, particularly since an important proportion of government revenues is now absorbed by contractual obligations, serious constraints are encountered in taxing business and financial incomes, and resorting to highly regressive indirect taxes can defeat the purpose. Thus, scenarios for creating "fiscal space for growth" through spending cuts and tax increases may, once again, prove to be over-optimistic exercises, particularly since the amounts required, in the order of 4–5 per cent of GDP, are quite large.

48. The prospects for making significant progress towards the MDGs have been further undermined by the ongoing global financial and economic crisis. The crisis has forced a number of countries to curtail their social spending to maintain macroeconomic stability and ensure debt sustainability.[7] In addition, government revenues have been negatively impacted by falling global demand and lower export earnings, FDI flows, and remittances. Moreover, the availability of external private finance has decreased over the last two years, and the cost of accessing international capital has risen for developing countries as the financial turmoil has deepened. It is likely that the cost of borrowing will be higher over the medium term. Consequently, for a growing number of developing countries, reducing the debt burden appears to be the only viable option for creating adequate fiscal space for the MDGs while avoiding another debt trap.

49. Despite these troubling dynamics, there are no mechanisms in place to provide orderly and adequate workouts for sovereign external debt, owed either to official or to private creditors. MDG-8 calls for a global partnership for development under which target number 3 calls for dealing comprehensively with developing countries' debt – the need for which has been amplified by the crisis. Addressing this gap in the international financial architecture remains an important ingredient of success in meeting the MDGs. Even with a more coherent international financial system, sovereign defaults are bound to happen. It is thus necessary to put in place a debt-resolution mechanism aimed at guaranteeing a speedy and fair resolution of sovereign debt crises. UNCTAD has proposed the creation of such a mechanism for a number of

[6] See Development Committee communiqué. 17 April 2005. Washington, D.C.
[7] As the European experience currently demonstrates, this is not just a developing-country problem.

years, and the current crisis has again demonstrated that the international financial system would greatly benefit from resolving debt problems in a rapid and equitable manner, and in a manner consistent with efforts to meet the MDGs.[8]

50. In addition to multilateral initiatives, attention also needs to turn to the domestic debt burden in a growing number of emerging-market economies. This is necessary not only to secure equitable treatment of domestic and external creditors. It is also needed because the continued servicing of domestic debt contracted at very high interest rates and concentrated in the hands of a small number of bondholders with highly regressive taxes causes greater difficulties in making progress towards the MDGs than servicing external liabilities. Inflating out of domestic debt is not a desirable option, but if more orderly and equitable ways cannot be found, governments facing serious fiscal difficulties may eventually be tempted to take such a course, with the attendant consequences for macroeconomic stability, income distribution and growth.

IV. Expanding policy options in support of the MDGs

51. The previous sections have suggested that development policy is about triggering and sustaining a cumulative and inclusive growth process around a strong investment and export nexus to generate more productive jobs, rising incomes and better social conditions. There is, of course, a danger that the resources needed to extend social protection will lag behind policy pronouncements and intentions, or be captured by special interests with little interest in a more inclusive development agenda, leaving large gaps in the quality and coverage of services needed to address human deprivation.

52. Strengthening the linkages between growth, employment, distribution and human development cannot be left to market forces, but requires a strategic policy agenda and appropriate institutional support. Investments in health, education and infrastructure – rather than speculative financial assets – are essential if growth is to be more inclusive.

53. Reductions in inequality as much as poverty per se are likely to support inclusive growth, because a more equal society is likely to see a faster expansion of the domestic market, ensuring economies of scale, improving access to domestic savings, and building greater resilience to outside shocks. Pro-poor macroeconomic policies, including in support of significant increases in public investment, will be an important part of the toolkit, along with industrial policies that encourage diversification and technological upgrading.

54. From this perspective, one of the least helpful ideas of conventional development thinking is that the State is an obstacle to economic and social welfare and should be “rolled back”. This is largely ideology, and ignores the fact that the State has always been an important actor *in* the market economy, and indeed an integral part of it.

55. In the years following the Second World War, the major achievement of the western democracies was to temper the conflicts generated by industrialization in the

[8] The primacy of social objectives over debt servicing by public agencies with governmental power is a recognized principle in national legislation in many industrial countries, notably in chapter 9 of the United States insolvency law.

nineteenth century and to avoid a repetition of the failures of market capitalism in the inter-war years of the twentieth century in such a way that full employment and economic growth could be combined with objectives for equity and social justice. The basic conclusion from this experience was that capitalism is most productive when it is embedded in a political and social system where its more destabilizing and destructive characteristics are subject to effective constraints and it is embedded in an inclusive social contract.

56. In many developing countries, success was associated with "developmental States" capable of raising investment to fuel economic growth, but also to guide investment into activities that could sustain a high-wage future for their citizens. This did not so much involve inventing a new set of policy instruments, as adapting a familiar set of macroeconomic, industrial, educational, financial and trade measures to a set of goals that were themselves evolving with each new stage in the development process.

57. None of this should be taken to imply that States are invincible or unable to fail, which is clearly not the case. Nor is it to deny that state-building in many developing and transition economies will have to tackle dysfunctional, and sometimes, corrupt administrations. What is important to remember is, firstly, that institutions emerge through long, and at times, painful historical processes, and many that are now regarded as prerequisites of successful economic development were the outcomes, rather than the causes, of economic development in today's advanced countries; secondly, that many developing countries today have a more solid institutional basis than today's advanced countries had when they were at similar levels of development; and finally, that there is considerable institutional diversity even among industrial countries today, and that imposing a common institutional standard on all countries, with widely varying conditions, is likely to be counterproductive.

58. The burden on national bureaucracies is certainly much heavier now than it was for earlier developers, because an increasing number of policies have become subject to international scrutiny and negotiation, while, at the same time, the international support for, and coordination of, those policies has weakened considerably. Moreover, moving to more inclusive development strategies certainly implies adding more policy instruments. However, there is still room to develop institutional capacity that provides a stable framework for economic activity, along with a vision of where society is heading and with sufficient flexibility to adapt policy goals and to make trade-offs in line with changing local conditions and constraints. The reregulation of financial markets in response to the massive shocks of recent years represents an important step not only in dealing with systemic risks but also in expanding the policy options available to countries seeking to establish more sustainable growth paths.

V. Conclusion: Towards an inclusive development agenda

59. It is important to recognize that in percentage terms, both income poverty and human poverty are still the condition of a substantial majority of the population in developing countries – both LDCs and emerging economies. Hence, the common assumption that poverty or human deprivation affects only a minority of the population is often misleading. This perspective has unduly narrowed the discussion of inclusive development to poverty reduction and the establishment of social safety nets.

60. Successful late-industrializing economies have stimulated fast growth, along with rising wages and benefits, as the basic foundation for improving economic and social welfare. However, such growth – because it is linked to both creative and destructive processes – can be a source of growing social divisions and distributional conflicts which can become entrenched and difficult to reverse. In response, policymakers have employed various redistributive and social measures in an attempt to make development more inclusive, including large public investments, more progressive tax systems, and the universal provisioning of social services, designed to manage the strains and stresses associated with rapid growth and structural change.

61. A good deal of controversy surrounding the use of social policy centres on whether efforts at alleviating poverty and increasing security should follow the principle of “universalism” or that of “targeting”. Since the 1980s, donor agencies have generally advocated targeting, usually both on efficiency grounds and as a response to binding resource constraints, on the assumption that one can alleviate poverty with fewer resources and a more limited role for the State. PRSPs have been particularly important in promoting a more targeted response to meeting social objectives, and private–public partnerships have often been the institutional vehicle of choice for advancing the social agenda. However, the evidence that such partnerships – which often amount to an expensive subsidy for private-sector service providers – bring real gains in terms of the cost and quality of social services is far from conclusive.

62. Moreover, experience with targeting has revealed several shortcomings, including high administrative and transaction costs, perverse incentives, and financial non-sustainability in the face of weak political support. Of particular concern is the way in which targeting, almost by definition, leads to segmentation and differentiation. In service provision, targeting can lead to a dual structure – one part created for the poor and funded by the State, and the other part created for the rich and supported by the private sector. Geographical targeting often leads to horizontal inequality, so that the poor in one area benefit more than the poor in another, non-targeted area. This combination of polarization and spatial inequality can be explosive politically, and can be the basis of ethnic conflicts.

63. In general, the experience points to the fact that targeting leads to reduced budgets devoted to poverty and welfare, so that “more for the poor means less for the poor”, suggesting that the optimal policy for the poorest and most vulnerable is not necessarily the one that targets benefits as narrowly and efficiently as possible.

64. In practice, most Governments tend to have a mixture of both universal and targeted social policies. The particular combination appears to be linked to how the developmental State manages developments in the labour market, beginning from modest and often means-tested programmes for limited groups of the population. However, early institutional solutions may have an effect on the later expansion and development of social programmes; for example, those that are first introduced based on the principle of economic means-testing may be more likely to develop into universal programmes than those that are established for clearly defined groups of the economically active population. In contrast, a focus on general education has proved to be of great importance for successful subsequent economic development and national wealth.