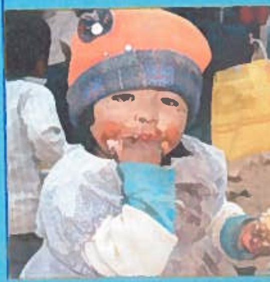
PRO-POOR ECONOMIC GROWTH RESEARCH STUDIES

CONTRACT NO. PCE-I-02-00-00015-00

Discussion Session: Phase I Findings and Results



Pro-Poor Economic Growth Research Studies
Discussion Session: Phase I Findings and Results

Tuesday, 25 February 2003
Radisson Barcelo at Dupont Circle (2121 P Street)

MORNING THEME
Pro-Poor Economic Growth Research Studies—Background, Outline and Foundations

1. **Introduction and Background—9:00-9:50am**
   Welcome by David Pottebaum.
   Introduction to Pro-Poor Economic Growth Studies Activity by Jim Elliot and Jonathan Conly.
   Presentation by Al Berry of (a) outline of our research program; (b) brief description of research framework; (c) what constitutes pro-poor growth and rationale for our definition; (d) selection criteria; and (e) country typology.

2. **Pro-poor growth and links among growth, inequality and poverty—9:50-11:00am**
   Panel: Gus Papanek and John Simon
   In this session, panelists will present and lead discussion on (a) relationships between growth, inequality and poverty; and (b) extent to which growth is necessary and sufficient for poverty reduction.

BREAK—11:00-11:10

3. **Importance of macro-policy—11:10-12:20pm**
   Panel: Al Berry, Peter Timmer and Clarence Zuvekas
   One of the most important factors bearing on many countries' success in poverty reduction are exchange rate and macro-economic management through their impact both on the rate of growth and on the pattern of growth. This session focuses on these issues and their impact on pro-poor growth, paying specific attention to the impact on poverty of differences in trade, monetary and fiscal policy and exchange rate management. The importance of macro-policy to agriculture performance, and agriculture performance to overall economic growth will also be discussed.

LUNCH—12:20-1:00pm

AFTERNOON THEME
Pro-Poor Policies and Programs

4. **Rural Poverty: Agriculture and Micro-Finance—1:00-2:10pm**
   Panel: Peter Timmer, Joan Parker and Thomas Hobgood
   In this session panelists will discuss pro-poor policies in the rural context. Panelists will focus on growth stimulating poverty reducing agriculture and micro-finance policies and programs.

BREAK—2:10-2:25pm

5. **Targeted Programs—2:25-3:35pm**
   Panel: Gus Papanek, Joan Parker and Tim Mahoney
   Discussion of the importance of labor intensive public works programs for raising income and other targeted interventions. The impact of HIV/AIDS on economic growth and policies to mitigate the negative effects on the productivity of rural poor will also be discussed.

6. **Summary and wrap-up—3:35-4:00pm**
   Al Berry and Tim Mahoney

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DISCUSSION SESSION: PHASE I FINDINGS AND RESULTS

by Albert Berry

INTRODUCTION AND DEFINITIONS

This document draws on the reports produced to date under Contract No PCE-1-02-00-00015-00 (Pro-Poor Economic Growth Research Studies), including:

- The literature review;
- The proposed typology of countries;
- The selection criteria for pro-poor economic growth producing policies;
- The preliminary list of such policies, reforms and activities; and
- The first completed country study (Peru).

It also reports briefly on the planned research for phase 2 of the Task Order, including the country studies, sector papers and short issue papers.

The broad objective of the Task Order is to provide a guide to USAID policy-makers on the best pro-poor policies for developing countries, depending on their particular structures and circumstances. The contents of the guide will reflect the conclusions on selection criteria (Deliverable 5, Selection Criteria for Pro-Poor Economic Growth Policies) together with the ongoing work on the policies, reforms and activities that appear to have been most successful in achieving pro-poor outcomes.

Definition of Poverty and of Pro-Poor Growth

There is no simple, generally accepted definition of poverty. The same, therefore, is true of poverty reduction and of pro-poor growth policies. The Pro-Poor Economic Growth Research Project adopts the widespread practice of defining people as "income poor" if per-capita family income or expenditure falls below a certain level (the poverty line) and of taking into account not only the number of such people (the head count) and their ratio to total population (the poverty incidence) but also how far their incomes fall below the poverty line (the poverty gap).

Another way to define poverty is in terms of unsatisfied basic needs, including food, safe drinking water, sanitation, basic education and basic health care. Income poverty and basic needs poverty are best seen as complementary measures allowing a richer understanding of a multifaceted phenomenon. A number of basic needs are in most countries provided by the state either free of charge (e.g., basic education) or for a fee (water and sewerage connections) so access to such services should be taken into account. Even broader definitions of poverty add concepts like lack of access to information, powerlessness, insecurity, and vulnerability. These multidimensional concepts are very difficult to operationalize and are beyond the scope of this Task Order due to the large effort required to

overcome the inherent complexities and to assure a meaningful integration and comparability across countries. Already the task of identifying pro-poor policies across the spectrum of policy areas using only the absolute income (or expenditure) definition is a daunting one. It is fortunate that in most cases policy conclusions are not greatly affected by the precise measure of poverty used, as long as it involves as its core element the absolute level of income (purchasing power) or consumption.

When poverty is defined in relative terms (where people with incomes less than a certain proportion the median income are counted as poor), the reduction of poverty becomes synonymous with the reduction of inequality within that part of the frequency distribution near or below the poverty line. Under the relative definition different policies would be needed to reduce poverty than under the absolute income or consumption standard, since only policies which had the effect of reducing inequality would now qualify as being pro-poor.

How Does Pro-Poor Growth Differ from Just Growth?

When one simply measures growth one does not take into account whose income is increasing; everyone might be sharing in the benefits of the growth but, alternatively, all of those benefits might be accruing to the rich and, an even more extreme possibility, the poor could be losing as the average income rises. Pro-poor growth is growth from which the poor are sharing at least to some degree in the additional income created. In other words, concern that growth be pro-poor reflects a second objective—the increased income and welfare of the poor.

As with income poverty, there is no single correct definition of pro-poor growth. One very important distinction is the degree of pro-poorness in different growth patterns. In particular, growth may be slightly pro-poor, moderately so or strongly so. To be considered pro-poor at all requires at a minimum that the incomes of the poor increase somewhat as growth occurs, i.e. that not all of the income increases accrue to the non-poor. The poor are better off by at least a minimal amount in this case. An intermediate situation would be one in which the incomes of the poor increased at the same rate as those of the non-poor. The fruits of growth would in this case be distributed in the same proportions as income was shared before. If the initial level of inequality was low such that the poor had a considerable share, then their share of the benefits of growth would also be substantial and such growth could be considered satisfactory from the perspective of the poor. If, on the other hand, the initial level of inequality was high and the share of the poor very low, then their share of the benefits of growth would also be low and such growth could not be considered very pro-poor.

Thus, in a country (say Brazil) where the top decile of the population was receiving 40 percent or more of total income and the bottom decile just 1 percent, the fruits of growth going to the top decile would also be 40+ times those accruing to the bottom decile, hardly a satisfactory outcome. In such inequitable situations a reasonable goal might involve the poor's share of the income increases brought by growth being some multiple of their initial share of income. If the bottom decile start out with 1 percent of income, the target might be

that they get 2 percent of income growth, i.e. twice their initial share. While their original income level would be a tenth that of the average person in the society, their share of growth benefits would then be one fifth that of the average person in the society. At the theoretical extreme, growth might be considered as 100 percent pro-poor if all of the income increases accrued to the poor. Such a situation would, however, be well outside the range of real world experience.

Whatever the specific definition of pro-poor growth, it is important to bear in mind the longer-run impacts of a given growth pattern. A given pattern may raise poor incomes rapidly in the short run but at the expense of further increases in the future. Income transfers from the rich to the poor that simultaneously damage future growth prospects are one example of such a trade-off. More generally one must take account of the positive long-term effects of increases in the income of the non-poor via savings/ investment/ demand on the income of the poor.

Selection Criteria for Pro-Poor Policies, Reforms, and Activities

The selection of pro-poor policies and programs calls for a clear definition of poverty and the application of cost-benefit principles. The process should include pre-implementation attempts to estimate probable benefits and post-implementation analysis of realized benefits. We can view poverty reduction as a benefit that society as a whole can purchase—that is, there may be a cost to the rest of the society in achieving such a reduction. Thus, the central criterion for policy selection is the activity's potential to reduce poverty in relation to the cost of that reduction.

In the most positive programs, there may be no net cost to the rest of society from the implementation of a particular pro-poor program. In all programs, it is desirable to achieve designed poverty-reducing effects at the minimum possible cost to the rest of society. Poverty reduction programs involve different types of costs. The simplest are the transfers from the rest of society to provide the resources for the pro-poor program. There are often also indirect costs and benefits, such as deadweight loss in the collection of taxes to run a program and the unintended consequences of the program on the rest of society. The actual cost of implementing a given anti-poverty program will be higher than the minimum theoretically possible level by an amount that depends on the administrative capacity of those implementing it, the efficiency of the tax system that raised the money to spend, the extent of cost-raising political opposition, and so on.

Typologies

A country typology is a classification system based on important economic features that distinguish countries, including structural features, temporal conditions, and policies. Typologies are particularly useful when the optimal policy package (including how its various components will be implemented) varies significantly across a range of country types.

Typologies based on structural features emphasize that effective pro-poor policy differs according to the absolute and relative availabilities of labor (quantity), skills (quality), and natural resources. Policy makers in countries with an abundant pool of relatively unskilled labor should design pro-poor policies to stimulate the use of excess labor, for example by using the exchange rate to increase exports of labor-intensive goods. Countries lacking in human capital must improve the coverage or quality of primary education and healthcare. Though countries with abundant skilled labor usually face a smaller challenge on the poverty front, pro-poor policies are still needed to increase the profitability of hiring unskilled labor and to upgrade the productivity of self-employed labor. In countries with abundant natural resources, industries that export natural resources typically do not generate many jobs so a small (in terms of employment) high-productivity sector and a large low-productivity sector typically polarize the economy; society suffers the associated income inequality. Such countries must design poverty reduction policies that invest the profits generated by resource exploitation in activities that train and employ the less skilled. At the same time, they must prepare society and the economy for the day when resources are less abundant.

The importance of making full use of the country's comparative advantage based on its resource endowment varies with how easily it interacts with world markets for goods and factors. Countries close to world markets, in terms of transport and communications costs, have great potential to benefit from international trade. Countries further removed from those markets have decidedly less potential. For these latter countries, the optimal pro-poor policy package involves greater attention to creating jobs in non-tradable sectors.

Other important structural features include the level of economic development, the degree of income and wealth inequality, and the quality of governance. The lower the average income of the country the less urbanized and the more agricultural it tends to be. In poorer countries, pro-poor policy should:

- Target large groups of people;
- Focus on raising productivity and employment opportunities in agriculture and in rural, non-agricultural activities;
- Ensure complete coverage of primary education and primary healthcare, especially in rural areas; and
- Exercise great care in the use of interventions to push wages above the equilibrium level because these interventions are more likely to help the non-poor than the poor.

In contrast, pro-poor policy in wealthier developing countries should:

- Aim to create employment outside agriculture, especially in small and medium-sized enterprises;

- Dedicate resources to pro-poor urban development, including sites and services programs, and extension of electricity, water, and sanitary services to poorer neighborhoods;
- Focus on increasing the quality of education received by the poor and improving their access to secondary education and vocational training; and
- Address the characteristic causes of poverty through targeted safety-net programs.

Effective pro-poor policy in a country with a high level of inequality will include programs to transfer productive resources to the poor, as with titling public lands to them (since a lack of resources is a proximate cause of poverty) and to provide them with appropriate technology. Weak administrative capacity (governance) means that many policies that might otherwise be carried out successfully cannot be. Under these conditions, pro-poor policy should normally involve only limited intervention. Finally, pro-poor policy needs to be applicable without modification to many groups rather than tailored to fit the needs of smaller groups.

Among typologies based on policies, the distinction between market and transitional economies is a key one. The transition from central planning to a market economy creates special challenges for pro-poor policy, partly because public enterprise is downsized before there is a reasonably productive informal or small-scale private sector to reabsorb displaced workers. In addition, some of the anti-poverty response mechanisms of market economies—such as fairly well functioning markets for the output of microenterprises and small firms, a capital market, and an informal labor market—are not yet performing well, leaving poor people with few opportunities. To reduce poverty in these economies, policy makers must pay special attention to achieving a rapid overall rate of growth. Many of the pro-poor policies implemented in market economies, however, are harder to implement given the lack of an institutional base for them. The development of a strong institutional base, especially to push rapidly ahead with the support system for small private enterprises, is thus another priority.

How and How Much Does the Pattern of Growth Matter to Poverty Reduction?

As long as the distribution of income stays constant as per capita average income rises, then poverty reduction is assured. But the magnitude of the benefits that accrue to the poor vary greatly depending on the pattern of growth. To illustrate, consider two countries with dramatically different levels of income inequality, say Taiwan and Brazil. Those differences are the product of radically different growth patterns in the past, though both countries have been fast growers during most of the last half-century. Every dollar increase in average per capita income in Brazil implies an income increase of 10 cents for the bottom decile of the population. In Taiwan the same increase in per capita income of a dollar implies an increased income of over 30 cents for the bottom decile. During Taiwan's period of greatest economic success and poverty reduction, when the incomes of the rural poor rose dramatically in the

post-agrarian reform period, they were getting over 40 cents for every dollar of gain to the average person.

A desirable pattern of growth in Brazil, evidently, would be one in which the poor got nearly as much as the non-poor out of every dollar of economic growth. This would imply a gradual reduction in the level of income inequality over time. It would be most easily achieved if more of the conditions and policies in Brazil approximated those in Taiwan. What are the conditions that facilitate or characterize pro-poor growth?

There are two main components of a pattern of growth that can reduce poverty rapidly, plus several less important ones. The two pivotal elements, which interact with each other in a mutually reinforcing way (for good if both are positive, for ill if both are negative) are:

- A structure of production which is intensive in unskilled labor and in any other factors of production which are widely held among the population; and

- A relatively egalitarian distribution of productive assets.

In lower income countries the asset whose distribution matters the most is land; in later stages that asset is human capital. Most other types of assets are usually rather or very unequally distributed, a feature which cannot easily be altered by public policy. For any given asset-holding structure, the level of inequality also depends on the composition of output. The more it can draw on unskilled labor and other widely held assets the more equal income distribution will be. In low-income countries there is usually a comparative advantage in labor-intensive products, in which case the vigorous pursuit of growth by specializing in and exporting these goods coincides with a good distribution of income and rapid poverty reduction. Again the case of Taiwan stands out. For countries with a less clear comparative advantage in such products, for whatever reason, growth is less likely to be poverty reducing. The often powerful interaction between these two key aspects of healthy growth involves among other things the fact that small farms (the pattern when land is equitably distributed) are usually substantially more labor intensive than larger ones. A similar pattern holds for smaller production units in other sectors. Although the question of which are the most important factors in a healthy pro-poor growth pattern naturally depends on the country, labor intensity of growth appears often to come first and the distribution of human capital second.

Among the other determinants of the poverty-reduction effects of growth is the extent to which markets work equitably, e.g. the degree of discrimination in the labor market, the capital market, and product markets. Although not inconsequential, this factor is much less important than the first two, from a quantitative perspective. It too tends to be correlated with the others in such a way as to accentuate their effects; thus severe labor market imperfections working against the poor are more likely to occur in a society already characterized by a high level of inequality from the other factors. Also significant is the degree to which public spending on infrastructure and on public services benefits the poor, both directly and by raising their productivity.

The relative importance of different types of assets changes as a country develops. Improving the poverty-reducing potential of growth in a low income country may necessarily entail achieving a more equal distribution of access to land. This tends to be very difficult politically. A few stages later in the process, it is the distribution of human capital that mainly matters, and here public policy may have great and more general potential. At still later stages of development financial assets become important in the overall stock of wealth; they are often quite unequally distributed and the market in which their prices are set tend to be highly imperfect which increases the level of inequality in the society and probably decreases the rate of growth. Corrective measures like the development of well-functioning microcredit systems can help to offset the effects of such imperfections.

PRO-POOR ECONOMIC POLICY: EVIDENCE AND HYPOTHESIS ON WHAT WORKS

This section draws on work in progress within the Pro-Poor project together with other sources in order to identify some of the important policy dos and don'ts in the area of exchange rate and macroeconomic management, international trade, and international capital flows.

The Exchange Rate, Macroeconomic Management, and Poverty Reduction

One of the most important factors bearing on many countries' success in poverty reduction are exchange rate and associated macroeconomic management, through their impact both on the rate of growth and on the pattern of growth.

The main key to success is an exchange rate which is not overvalued and which thus provides a strong and balanced price incentive to exports and to import competing goods and services. A relatively stable real exchange rate also appears to be important for many economic agents, especially smaller firms engaged in international trade or finance and not in a position to hedge. Major threats to the maintenance of a low (i.e. not overvalued) and stable real exchange rate are internal inflation (usually due to loose monetary and/or fiscal policies) that is not offset by nominal devaluation, and unstable capital flows into and out of the country.

Very high rates of inflation are likely to be damaging to growth. Fairly high rates, say in the range of 20 percent per year, can be dangerous if they eventually lead to runaway inflation. If they do not, and also do not lead to exchange rate overvaluation (as they often have in the past) it is unclear whether such levels of inflation, maintained fairly constant, have any general and significant effects on poverty.

Severe tightening of macroeconomic policy tends to lead to recessions is thus correlated with increased poverty. Depending on the circumstances that poverty increase may be correctly blamed on prior looseness of macroeconomic policy, on unstable international capital flows, or on unavoidable reduction of import flows (e.g. due to a worsening of the terms of trade). The question of which costs are avoidable and which are not is a complicated and contentious matter. Within this debate, however, there appear to be strong grounds for the

view that pain borne in order to rectify balance of payments disequilibrium and to assure strong price incentives to exports and import competing industries is more likely to bear fruit in the form of growth and poverty reduction than is pain borne simply to lower the rate of inflation, unless that rate is in or threatens to move to the danger zone.

International Trade, Capital Market Opening, and Poverty Reduction

Trade and Growth. The presumption of the Washington consensus is that freer trade should significantly accelerate growth in developing countries. Moreover, much standard trade theory suggests that protection against imports hurts the relatively abundant factor, which in low-income countries is unskilled labor. Thus freer trade should improve income distribution. Many studies have tried to estimate the effects of trade policy on growth. A few have examined its effect on inequality. Neither sets of evidence provides solid support for the Washington consensus view.

The general literature on the impact of trade on growth is ambiguous both on the theoretical (e.g., Grossman and Helpman, 1991) and on the empirical side. There is considerable agreement among trade economists that freer trade can often improve the efficiency of resource use, especially relative to the highly protected developing economies. It is far less clear whether freer trade will accelerate capital accumulation or technical change. On the empirical side, Harrison and Hanson (1999, 127-8) note that though most of the early empirical studies found a consistently positive relationship between trade and growth, many of the more recent ones do not, including both cross-country comparisons and individual country case studies focusing on intersectoral productivity growth. This conclusion is broadly consistent with that reached by the ECLAC team for the Latin American case.

Trade and Inequality. As with the impact of trade on growth, there is nothing approaching a consensus as to its effects on inequality. These are complicated and probably vary widely by type of country, economic setting, and other factors. While Bourguignon and Morrison (1990) offer significant empirical support for the proposition that trade protection results in greater inequality, Higgins and Williamson (1999) found that although open economies possessed significantly lower Gini coefficients in the 1960s, this was not the case thereafter. A recent body of literature tends to blame either increasing economic openness or the market-friendly reforms more generally for a tendency towards worsening of intra-country inequality during the last decade or so. But the analysis of this pattern has not yet advanced far enough to clarify whether there was an important causal link and if so what were the main mechanisms at work.

If the benefits of trade liberalization for the poor are not systematically large, ,does trade cease to be relevant in pro-poor policy selection? This would not be the most logical conclusion to draw from the confusing empirical evidence on the table. Rather, it is much more likely that some forms and degrees of trade liberalization benefit the poor substantially in some sorts of countries and in some contexts, but not in others. No doubt short and long run impacts also differ substantially in some cases. The fact that the predictions of the simplest trade-related theories as to growth and distributional effects have not proven out

across the board suggests the need for more sophisticated theories, and for more recognition that context matters and that not all developing countries are the same. Thus, the argument that when trade expansion involves highly labor intensive products it should improve income distribution remains convincing, both on theoretical grounds and because the experiences of countries like Taiwan bear out the positive expectations

Capital Flows

The logic of the international financial opening undertaken by many developing countries over the last few decades is to better access foreign capital and thus raise investment and speed up the rate of growth. Such opening up has not yet performed at a level close to the expectations, highlighting a number of problem areas and challenges for the future. The problem areas include the following:

- The close association between financial liberalization and financial crisis, with the latter being seriously damaging to growth;

- The tendency for rapid capital inflows to lead to overly appreciated exchange rates which makes it more difficult to export products, including labor intensive ones, and often has a dampening effect on economic growth;

- The possibility that financial opening, through its effect of raising the share of banking done by large foreign banks will lower the access of small and medium enterprises while lowering the cost of capital to large firms which have increasing access to low cost international capital markets; and

- The relative exclusion of many poorer LDCs from access to foreign capital and its therefore limited capacity to provide benefits to many of the world's poor.

The losses associated with the first two problem areas have been evident and widely discussed. The third remains a matter for further research.

Making international capital flows work better for developing countries clearly involves both improvements in the international financial architecture and in the performance of national financial systems. Much controversy has surrounded the question of whether countries should attempt to impose some degree of controls on capital flows and whether even if they should and do try, they can have much success in doing so.

Ongoing Research

At this time one sector study (agriculture) is in draft, the remaining two in progress. The country study of Egypt is in draft while those of the Ukraine, Indonesia, and Sri Lanka are underway and those of Brazil, Uganda and Zambia will soon be started. The issues paper on health is in draft, the others at various stages of progress.

The main tasks that lie ahead are:

- To integrate the policy lessons from the country studies with the recommendations coming from the sector and issues papers;
- To attempt to reach defensible recommendations in those important policy areas where the evidence is still controversial;
- To relate recommendations as much as possible to the country type and economic settings where they are most promising; and
- To present the policy recommendations in the guidance manual in the most useful and user-friendly way as possible.

EXECUTIVE SUMMARIES

EXECUTIVE SUMMARY

In 1999, the World Bank and IMF initiated the Poverty Reduction Strategy Paper (PRSP) process. Initially a mechanism to guide resources freed by debt relief through the Heavily Indebted Poor Countries Initiative, PRSPs have become the basis for World Bank and IMF concessional loans and are increasingly seen as the main development policy document of the countries involved. Indeed, the World Bank and IMF promote PRSPs as a mechanism to improve donor coordination and focus their resources on achieving meaningful results in reducing poverty. PRSPs have the potential to improve previous strategy formulation processes and outputs, mainly because of their use of participatory approaches. Participation of a broad spectrum of civil society, including the poor, should increase country ownership of the resulting strategies and lead to better priority setting, decision making, and poverty reduction policies. Participation also can place greater responsibility and accountability in the hands of the government.

Sixty-four countries currently participate or actively plan to participate in the PRSP process. Since March 2000, 21 countries have completed PRSPs, and another 28 have completed interim PRSPs. Most PRSPs (13 of the 21) and interim PRSPs (16 of 28) were prepared by African countries. Only two countries in Asia and two in Latin America have produced PRSPs.

This desk review consulted a variety of sources, including most importantly the recent World Bank/IMF internal review of the PRSP process and a number of the many analyses by external critics of the process. It also consulted country-produced PRSP documents and sought input from field-level participants and observers of the PRSP process.

Findings

This review begins with an overview of the PRSP process and the findings of a recent World Bank/IMF-led review of it. In their review, the World Bank and IMF judge that in general PRSPs are achieving their objectives and gaining widespread acceptance, as indicated by the growing participation of both low-income countries and other donors. They report that the process is helping promote broader national dialogue on poverty reduction policies and interventions, better decision making by national authorities, and more effective use of public resources to fight poverty. At the same time, the World Bank and IMF recognize that PRSPs are a major challenge for the countries involved. The technical requirements are high, and requirements for broad participation call for new skills and great patience. Difficulties in conquering these and other challenges have forced the World Bank, IMF, and countries involved to lower their expectations for the quality of the process and the outcome of initial PRSP activities.

Many participants and observers have heavily criticized the PRSP process since its inception. They believe that PRSPs fall far short of the high expectations raised by the World Bank and IMF in 1999, that their content represents nothing new, and that they are simply a cover for

standard economic targets and structural adjustment conditions. The strongest critics argue that PRSPs do not address the real needs of the poor and will have at best a marginal impact on poverty. According to its critics, the main failings of the PRSP process include:

- *Stakeholder participation is well short of expectations.* Meaningful participation of a broad spectrum of society has not occurred in most cases, leading to criticism that participation is sought only to legitimize already formulated plans.

- *Countries involved are not gaining greater ownership of the process and resulting policy packages.* Heavy World Bank/IMF involvement throughout the process—including veto power over final documents—leaves them with an excessive degree of control and influence over country policy and strategy choices.

- *Policy content is mainly unchanged from the failed and impoverishing structural adjustment policies of previous strategies.* Underlying this source of disagreement is the near absolute faith PRSPs appear to place on growth as the engine of poverty reduction.

- *Governments and civil society organizations lack the human and financial resources to adequately formulate and implement PRSPs.* Proper implementation of the PRSP process requires many types of skills that are beyond the reach of most countries. Donors provide some but not enough and not the right type of assistance to facilitate meaningful participation and effective implementation.

Despite its failings, the PRSP approach has the potential to assist countries in formulating and implementing appropriate policies to reduce poverty. Its core principles are well suited to the development and implementation of appropriate and effective poverty reduction strategies. The practice of the PRSP approach appears to have led to some tentative improvements, including more specific targeting of poverty reduction in national strategies and budgets, increased government awareness of the complexities of poverty, and improved dialogue between policy makers and civil society.

Recognizing that it is difficult at this time to demonstrate conclusively the impact—potential or otherwise—of PRSPs on poverty reduction strategies and outcomes, this review suggests that on balance the PRSP approach can add value to the *decision-making process* by which countries formulate national strategies and to a *transformation of policy environments* into something more friendly and responsive to the poor and thus more effective in reducing poverty. It is important to keep in mind, however, that evidence to support this conclusion is decidedly mixed and that much needs to be done to improve the PRSP process and consolidate its achievements so far.

Specifically, the World Bank, IMF, and the countries involved must address five interrelated challenges for the PRSP approach to achieve its potential:

- *The basic framework of the PRSP approach must be improved.* Most importantly, adjustments are needed to close the gap between expectations raised by the PRSP process

vis-à-vis country ownership of poverty reduction strategies and the realities of the ongoing relationship between the World Bank/IMF and participating countries.

- *Formulation of PRSPs—i.e., implementation of the approach—must be improved.* A critical issue is the short time frame typically allocated for the production of PRSP documents. Factors that motivate their quick development must be removed and quality of design given priority over meeting arbitrary deadlines. Furthermore, participation must be broadened and made more meaningful.

- *Countries must improve their technical capacity to determine the correct steps to reduce poverty.* Governments and civil society need to improve their capacity to work together and conduct the many required tasks called for by the PRSP process.

- *Countries and donor agencies must ensure that governments have the administrative capacity to operationalize the poverty reduction strategies.* PRSPs place new responsibilities on ministries that typically lack the technical and operational expertise required. They also correctly call for civil society organizations to take on major responsibilities in monitoring implementation of the strategy even though they often lack the skills and experience to do so.

- *Finally, PRSPs, like all programs that call for policy and budgetary reform, face severe political challenges.* Powerful figures who are opposed to changes envisaged by PRSPs should not be allowed to derail implementation of the strategy. As the PRSP process is improved and final policies and strategies become more sound, implementing reforms that confront vested interests will be a great challenge that cannot be finessed or side-stepped.

In addition to its potential to assist efforts to reduce poverty, the PRSP process also represents fertile ground for the investigation of how we might formulate and put pro-poor policies into practice. As the Pro-Poor Economic Growth Research Studies Activity moves forward, it will be important to continue to learn from the PRSP process. The PRSP approach might illuminate, for example, how best to sequence the policy and implementation decision-making processes. We also can learn from an investigation of any gaps between policy packages recommended by the PRSPs and this research project. In addition, PRSP implementation experience can provide useful lessons on how to improve monitoring and evaluation systems that track the progress of poverty reduction efforts.

EXECUTIVE SUMMARY

Over the last three decades, the share of world population that is poor has declined significantly. The rate of decline has, however, slowed over the last two decades. Looking beyond global aggregates reveals that there is a wide variation in poverty rates (as measured by $1 per day poverty line) across countries and regions. Indeed, between 1970 and 1998, the poverty rate increased significantly in Africa while it decreased in Asia and Latin America.

These developments have sparked much discussion regarding the growth-promoting "Washington Consensus" and the related question of whether growth is sufficient everywhere to reduce poverty and ultimately to promote equitable development. The wide variance in poverty rates between countries exhibiting similar growth rates supports the notion that growth may be necessary but is not sufficient for maximum poverty reduction. Key questions for policy makers thus include: What factors cause such variations in poverty? How can these factors be harnessed to facilitate pro-poor growth? This paper examines the most significant policy and academic literature related to pro-poor growth to ascertain how pro-poor growth can be effectively promoted.

Much of the debate surrounding poverty reduction focuses on the relationship among inequality, economic growth, and poverty. Empirical evidence suggests that both growth and inequality have important effects on poverty reduction and that there are also important interactions between the two. For example, some studies show that inequality hinders growth. More specifically, economies that exhibit a high level of initial inequality grow less quickly and achieve less poverty reduction from the growth that does occur . This finding does not imply that inequality should be reduced by any means necessary. If inequality is reduced at the expense of growth, prospects for poverty reduction may be seriously harmed. The key to poverty reduction is thus to promote strategies that strike a balance between fostering growth and achieving greater equity. The strategy choice is critical because, if redistributing wealth to the poor comes at the cost of future growth, poverty reduction today may come at the price of greater poverty tomorrow.

The literature highlights the potential for policy to influence the level of inequality and pace of growth. Broadly speaking, policy areas can be identified that facilitate simultaneously the acceleration of growth and the spreading of incomes more evenly:

- **Expanding Basic Educational Opportunities.** An expansion in primary and lower secondary school achievement can accelerate economic growth and narrow income inequality. Conversely, initial expansion of elitist levels of education sharpens income disparities;

- **Expanding Access to Quality Primary Health Care and Combating Communicable Diseases;**

- **Reducing Biases against Agricultural Competitiveness,** including trade policy reforms, may be particularly effective in reaching the rural poor while enhancing overall

efficiency under conditions of equitable access to land and other factors of production. However, where inequality is high in rural areas, even agricultural growth may do little to alleviate poverty;

- **Reforming Trade.** Removing biases against producing low-skill, labor-intensive manufactured exports in low-income countries directly raises the earnings of the urban poor;

- **Limiting Taxes and Labor Market Regulations that Raise Labor Costs Unduly,** encourages more efficient use of labor, and enables trade and other reforms to create jobs;

- **Improving the Poor's Access to Credit and Land and Other Natural Resources** and control over the natural resources;

- **Promoting Development Policies that Address the Direct Links among Poverty, Inequality, and Violent Conflict in Post-Conflict Environments.** In so doing, policies that target the poor and seek to minimize social and economic inequality should be promoted;

- **Vigorously Combating HIV/AIDS.** HIV/AIDS not only increases the scale and depth of poverty for sufferers, but also can significantly reduce growth at the sectoral and national levels by affecting labor productivity and overall production and domestic market demand; and

- **Promoting Public Workfare Programs and the Provision of Social Safety Nets in Cases of Transient Poverty Caused by Crises.** Transient poverty is a particularly important phenomenon in the context of short-term crises. For it is during these periods that families are at risk of either being thrown into poverty or falling deeper into it. The danger of transient poverty is that it may result in long-term indigence.

Finally, the new Washington Consensus—if it exists—is directly concerned with reducing poverty and has advocated decentralization as a tool to achieve this goal. There is no clear evidence that decentralization is an effective strategy for poverty reduction. As such, promotion of decentralization as a means for poverty reduction should be approached with caution.

The question of how to promote pro-poor growth is highly complex. As this literature review highlights, some tentative conclusions have been drawn with regard to the factors that must be considered in the design of appropriate pro-poor policies, but the debate is still unfolding. This literature review is intended to inform the further work of the Pro-Poor Economic Growth Research Studies Project. The project will produce a number of in-depth studies on topics dealing with the issue of how to achieve pro-poor growth. For a more detailed discussion of some of the topics covered in this review, please refer to the list of project deliverables printed on the inside cover of this document.

EXECUTIVE SUMMARY

Peru fell seriously behind the rest of Latin America in the last three decades of the 20th century. Its gross domestic product per capita in 2001 was no higher than in 1970. Short periods of economic growth have repeatedly raised hopes of more successful performance, but just as repeatedly the hopes have been disappointed by offsetting downturns. The worst downturn was in the late 1980s, when GDP per capita fell by one-third. The incidence of poverty increased from 42 percent in 1986 to 55 percent in 1991.

In the 1990s, with economic liberalization at the beginning of the decade and the end of the extreme violence of Sendero Luminoso, the economy went through a period of recovery and rapid growth. From 1992 to 1997, the incidence of poverty declined from 55 to 51 percent. But growth stopped again and did not show signs of revival until 2002. When growth stopped, the incidence of poverty increased again, to 54 percent. However, the results were better for reduction of extreme poverty (families with incomes below the cost of even minimally necessary nutrition). The incidence of extreme poverty declined, from 24 percent in 1991 to 15 percent by 2000. That achievement resulted, in part, from social programs focused on rural districts characterized by high levels of extreme poverty.

The main frustration for Peruvians in the last decade has been finding employment that is sufficiently productive to enable them to get out of poverty.

Even in the period of high growth from 1994 to 1997, employment conditions remained so weak that real wages of hourly paid production workers fell. For the private sector in Lima, the share of workers with regular jobs in formal employment fell from 54 percent in 1990 to 46 percent in 1997; it decreased despite the strongest economic growth the country has known for several decades. One great disappointment of the 1990s was that economic liberalization, and better economic growth, did not do more to improve the balance between the overwhelming numbers of low-skilled workers and the limited opportunities for productive employment.

A major reason for this failure to make more progress in improving employment opportunities and reducing poverty is that the country's structure of comparative advantage, led by the mining sector, constrains the power of growth to improve employment opportunities. That structural handicap could have been reduced by managing exchange rates to raise incentives for exports and growth in manufacturing, non-traditional agriculture, and modern services. It was a costly mistake, from the viewpoint of efforts to reduce poverty, to allow an appreciation of the real exchange rate at the time of liberalization and to maintain it until nearly the end of the decade.

Other factors have kept poverty at high levels. One factor is that the supply of arable land relative to the agricultural labor force is exceptionally low, which makes it difficult to escape poverty in agriculture and also drives people into the cities, adding to downward pressures in urban labor markets. Another factor is that the low quality of public education restricts the flexibility and learning capacity of the labor force, holding down competitive strength in non-

traditional fields. A third factor is that the level of taxation is too low to provide sufficient financing for social investment. Peru achieved a major institutional innovation in the 1990s with a new tax agency that raised the efficiency of tax collection—to prove that taxes can be collected in Latin America—but the agency itself needs more protection from political manipulation and the tax system needs to be restructured to raise revenue relative to GDP. Economic liberalization and greater fiscal and monetary restraint helped reduce inflation and set the stage for better growth but by themselves are not adequate answers to the country's problems. These policies need to be complemented by active promotional policies—social programs, taxation, and exchange rate management, in particular—if Peru is to make sustained progress in reducing poverty.

The goal of the USAID-funded Pro-Poor Economic Growth Research Studies and Guidance Manual Activity is to identify and disseminate policies, reforms, and activities that USAID decision makers can incorporate into their programs and that they can recommend to countries wishing to pursue strongly pro-poor, poverty-reducing, economic growth objectives.

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