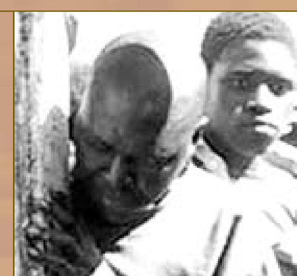
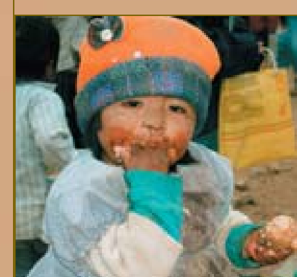
USAID OFFICE OF POVERTY REDUCTION
PRO-POOR GROWTH RESEARCH STUDIES

Pro-Poor Growth: A Guide to Policies and Programs





U.S. Agency for International Development
Bureau for Economic Growth, Agriculture, and Trade
Office Poverty Reduction
Poverty Analysis and Social Safety Net Team

FOREWORD

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

Dear Colleague:

The Bureau for Economic Growth, Agriculture and Trade is pleased to present *Pro-Poor Growth: A Guide to Policies and Programs* prepared by the consulting firm Development Alternatives, Inc. (DAI) working in collaboration with the Boston Institute for Developing Economies (BIDE) under the auspices of USAID's Pro-Poor Economic Growth Research Studies Activity. Through this activity USAID supports the work of prominent researchers examining the complex relationship between economic growth and poverty reduction. Their findings, recommendations and conclusions have been documented in a series of issues papers and sector and country studies. The *Guide* captures and synthesizes this work. I hope you find it informative and relevant to your work.

With this *Guide* providing an analytical foundation, USAID plans to develop a poverty reduction research agenda focusing on the relationship between sectoral development and macroeconomic policy. We will examine the influence of public policy on the ways in which the poor work, save, and invest. The agenda will pursue topics pertaining to property rights, financial development, educational achievement, debt, and inflation.

Any and all studies and papers produced by this activity are available in hard copy. Titles are listed on the inside of the *Guide's* cover page.

Sincerely,

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Assistant Administrator
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PREFACE

The USAID Pro-Poor Growth Research Studies activity was a collaborative project undertaken by the Boston Institute for Developing Economies (BIDE) and Development Alternatives, Inc., (DAI). The development of this guide was very much a team effort. We assembled a multidisciplinary group of experts in the many different fields and disciplines that are needed to understand pro-poor growth. Country case studies, sector studies, issues papers, and other reports were written by leading specialists, most with distinguished research records. Our team members and contributors are identified below.

The idea of pro-poor growth is still quite controversial within the development community. Definitions vary, and on many specific policy issues there is no consensus in the economics profession, even within a specific country context. Our multidisciplinary team members approached common issues from different perspectives and different country or area experiences, writing with different styles, giving emphasis to different themes. From this came great richness of insights, but also far more diversity than a reader of this guide would find useful. The DAI/BIDE Core Project Team thus met periodically to discuss major substantive issues to reach agreement on recommendations. Debates took place on, for example, exchange-rate management, the role of inflation, the effectiveness of targeted programs, and the factors conditioning the relationship between the rate of growth and poverty reduction. We have attempted to present the consensus here. In an effort to harmonize the "voice" of the guide, Gustav Papanek and Albert Berry provided the final editorial review.

Commencing in September 2002, our work in progress was periodically presented and extensively discussed with the USAID Pro-Poor Growth Research Studies Team and other interested USAID staff. Three full-day workshops were held in Washington, D.C., in February, July, and December 2003. An additional half dozen smaller group discussions took place with the USAID Team over the course of the activity. We are deeply grateful to our colleagues at USAID for their thoughtful comments and their cooperative approach to completing this task. Needless to say, they bear no responsibility for the final recommendations. Ultimately the responsibility is ours.

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Pro-Poor Growth: A Guide to Policies and Programs

Summary and Overview:	Gustav F. Papanek and Albert Berry
Chapter One:	Karin Schelzig
Chapter Two:	Gustav F. Papanek
Chapter Three:	Albert Berry and Gustav F. Papanek
Chapter Four:	Jere R. Behrman, Joan C. Parker, James C. Knowles, Albert Berry, and C. Peter Timmer
Chapter Five:	Samuel A. Morley and Gustav F. Papanek
Chapter Six:	Catherine Dolan, David A. Pottebaum, Leroy P. Jones, Robert Repetto, Federico S. Fische, and C. Peter Timmer
Chapter Seven:	Gustav F. Papanek and Albert Berry
Chapter Eight:	C. Peter Timmer
Annexes:	Karin Schelzig

HOW TO USE THIS GUIDE

Pro-Poor Growth: A Guide to Policies and Programs is designed to be used in several ways by a broad audience of development practitioners. It does not have to be read straight through from beginning to end. Instead, each chapter provides a different entry point to the macro, sectoral, and targeted policies and programs that interact to make growth more pro-poor. Real-world examples are woven throughout but are also summarized in Chapter Seven, which conveys the policy lessons from eight country studies. (The country studies themselves can be found in their entirety on the enclosed CD-ROM, in addition to the sector studies, cross-cutting issues papers, and other reports resulting from the USAID Office of Poverty Reduction's Pro-Poor Growth Research Studies project.)

IS THE PRO-POOR GROWTH GUIDE FOR YOU?

If you have come this far, the answer is yes. Specifically, the guide is meant to help the senior USAID officer involved with strategic results planning, the economic-growth officer working on country strategies, and the field-based program officer designing a new technical assistance project. *Pro-Poor Growth: A Guide to Policies and Programs* is a hands-on guide. It is not a cookbook, and the contents are not recipes. Collected in this guide are insights, guidelines, and examples to help you think about economic growth and poverty reduction.

HOW IS THE PRO-POOR GROWTH GUIDE ORGANIZED?

Chapters One and Two are brief overviews that set the stage for the discussion of pro-poor growth. What is poverty? How do we conceive of pro-poor growth? Laying out these themes in broad terms, both chapters contain resources sections with useful Web sites and key references for further reading.

The heart of this guide comprises Chapters Three through Six. Each chapter is set up in a similar manner: substantive issues, policy recommendations, and further resources. The logical progression of the four chapters is from the macro level via sectoral policies to targeted programs and cross-cutting issues.

Chapter Three, "The Broad Policy Setting," first looks at macroeconomic and trade policies. Well-designed macroeconomic policies are key to rapid growth, and rapid growth is essential for sustained poverty reduction. The second half of the chapter covers labor and employment policies. The main objective of all pro-poor policies affecting the levels and conditions of employment is to raise the value of labor, the most important asset owned by the poor.

Chapter Four, "Sector Policies and Programs," examines four key sectors and their relationship to pro-poor economic growth: education, health care, finance, and agriculture. Education is central to promoting efficient growth and for increasing the productive potential of the poor to raise them out of poverty. The health-care sector priorities that contribute most to pro-poor growth are those that increase the supply and productivity of labor, complement human capital investments, and reduce the dependency burden. A pro-poor financial system helps to reduce poverty through impacts on both the pattern and the pace of growth. Finally, the performance of the agriculture sector (and the rural economy, more broadly) is a key factor influencing the rate of overall economic growth and its impact on the poor in those countries where poverty is most severe.

Chapter Five, "Targeted Programs and Social Safety Nets," examines social safety nets and their role in supporting pro-poor growth. Targeted programs and interventions are designed to raise the incomes of the poor and mitigate the effects of poverty and other risks on vulnerable households. Specific programs discussed here include conditioned cash transfers, subsidies, and labor-intensive public works. Self-targeting is highlighted as the most successful method for minimizing leakage of safety net program benefits to the nonpoor.

Chapter Six, "Cross-Cutting Issues," explores pro-poor growth in several specific cross-cutting contexts: gender, the environment, conflict, privatization, and governance. Each section provides a brief overview of the issues, makes concrete policy recommendations, and provides references for further in-depth reading.

Chapter Seven, "Policy Lessons from Eight Country Studies," summarizes key lessons drawn from the country case studies (Brazil, Egypt, Indonesia, Peru, Sri Lanka, Uganda, Ukraine, and Zambia) undertaken as part of the USAID Pro-Poor Growth Research Studies project. The lessons are organized thematically rather than by country, following the structure of the guide as a whole. Some readers may wish to enter the guide from this chapter by focusing on the countries or regions and issues of most interest to them.

Chapter Eight, "Poverty Reduction and the International Donor Community," serves as a brief guide to the Poverty Reduction Strategy Paper (PRSP) process. PRSPs are the main vehicle for donor coordination on poverty reduction and buy-in from the countries themselves.

The annexes to this guide provide additional resources for the development practitioner: a glossary (Annex 1), an annotated list of poverty and growth Web sites (Annex 2), and a poverty measurement primer (Annex 3). The primer covers the basic issues in poverty measurement and provides, as elsewhere in the guide, several resources for more in-depth study. Annexes 4 and 5 provide the country study executive summaries and the contents of the CD-ROM, respectively.

Do the Guide's Policy Recommendations Apply Everywhere?

The short answer is: not necessarily. We have attempted to generalize as much as possible, but the reader must interpret the conclusions and policy recommendations in the context of any given country's setting and political economy. Some desirable policies may simply not be possible in certain countries. Or there may be inevitable negative effects that render them unattractive even if they are feasible. Because of the enormous variability across countries in both economic structure and political economy factors, there may be exceptions to any generally valid policy conclusion.

We hope you will find *Pro-Poor Growth: A Guide to Policies and Programs* useful and informative, as both a general reference document and a functional tool to support poverty reduction efforts.

Bethesda, Maryland
January 2004

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EXECUTIVE SUMMARY: THE POLICY RECIPE FOR PRO-POOR GROWTH

Pro-Poor Growth: A Guide to Policies and Programs identifies the most important operational elements of rapid pro-poor growth. The key to poverty reduction in the medium term is growth that is sufficiently rapid to absorb additions to the labor force and to make inroads on unemployment and underemployment. Well-designed macroeconomic policies are the foundation of rapid growth.

MACROECONOMIC AND LABOR POLICIES

The more labor-intensive the growth, the more it contributes to poverty reduction. Therefore, macroeconomic policies need to provide incentives not just to rapid growth but also to rapid labor-intensive growth. In the early stages of development, this often means an emphasis on labor-intensive agriculture, construction, and import-substituting manufactures. Quite soon, incentives need to encourage labor-intensive manufactured exports. In middle-income countries, it still matters that rapidly growing sectors be relatively labor-intensive, even if they are not absolutely very labor-intensive by world standards.

The exchange rate is the most important policy tool for the efficient production of goods and services that take advantage of the abundant labor in poor countries. The primary requirement is to avoid overvaluation, which usually occurs as the result of capital inflows, a rise in the price of exported materials, or other temporary shocks. In many countries, a modest undervaluation will help overcome infant industry or learning-by-doing problems and assist countries to break into the world market.

Accelerating inflation or very high rates of inflation harm the poor. Therefore, the next requirement for good macroeconomic policy is to use monetary and fiscal policy to avoid accelerating inflation. Excessive fiscal deficits, which spark inflation, hurt the poor.

Government interventions that distort the economy reduce efficiency and slow growth. Any needed interventions should minimize distortions. Policies that make labor expensive and capital and foreign exchange cheap are especially undesirable because they make growth less labor-intensive and therefore less pro-poor. The cost of machinery is reduced by interest-rate subsidies or controls; lower tariffs and taxes on capital goods; and an overvalued currency, which lowers the cost of imported machinery. The cost of labor is raised by effective minimum wages and extensive labor protection legislation. Both help workers employed in the organized sector and harm those outside, most of them poor. For some measures dealing with health, safety, and the right to organize, the benefits are so large that they can be justified despite any impact on employment.

SECTORAL PRIORITIES

Governments need to focus sectoral efforts on:

- Investing in education and health care to equip the poor for higher earnings. Whether investments in expanding the reach of the system or in increasing quality have a higher rate of return depends very much on country-specific circumstances.
- Raising productivity in agriculture and lowering the price of food, by adaptive research, development of the rural infrastructure (especially roads and irrigation), and temporary subsidies to speed the adoption of new technologies by the poor.
- Providing selective support for sectors and groups of firms that employ large numbers of lowly skilled people; for instance, helping with the start-up or investment costs of banks serving small firms and low-income people.

TARGETED PROGRAMS AND SAFETY NETS

Effective targeted programs or social safety nets need to be an essential part of the poverty reduction arsenal to help people or regions left behind; provide support during inevitable economic setbacks or natural disasters; and retain support for difficult economic reforms.

Effective targeting of the poor is crucial. Many subsidy and other programs have become so expensive that they actually hurt the poor by slowing growth, because most of their benefits go to the nonpoor and to administration. Self-targeting is often the most effective—only the poor want the goods or services. The best programs not only provide employment and income but also create infrastructure (through labor-intensive public works) or provide an incentive for human-capital accumulation by keeping children in school.

CROSS-CUTTING THEMES

Key *gender-related* pro-poor policies include support for sectors that employ many low-income women and gearing infrastructure and other public investments to raise female earning power.

Well-designed *environmental* protection policies can be both pro-poor and pro-growth, especially in countries where the poor are major users of environmentally fragile resources.

In countries suffering current or recent *civil conflict,* special steps to defuse conflict are often a necessary condition before normal growth processes can successfully resume.

Policymakers must be aware of *political economy* considerations that in particular countries may render some otherwise beneficial policies impossible or undesirable because of associated negative consequences.

Improved *governance* can make a big difference to the rate of growth. It is especially important for the poor, who are least able to defend themselves against corruption and powerful interests where the rule of law is weak. In a few countries, rapid growth and poverty reduction are unlikely without a reduction in the distorting effects of corruption. Most changes needed to improve governance affect power relationships or require institution-building, both usually slow processes, but macroeconomic policy changes that reduce the burden on government and the opportunities for corruption can lead to quick improvement.

COUNTRY CONTEXT IS KEY

Because of the enormous variability across countries in both economic structure and political economy factors, there may be exceptions to any generally valid policy conclusion.

OVERVIEW OF MAIN CONCLUSIONS

THE NATURE OF POVERTY AND PRO-POOR GROWTH

Poverty clearly is multidimensional. To be poor means not only to have a low income, but also to lack assets and access to social services; to be especially vulnerable to the risk of disease, accident, environmental degradation, and natural or economic catastrophes; and to be relatively powerless. This guide focuses on the core indicator and determinant of poverty: absolute income poverty. It is the most manageable concept to measure, to make operational, and to affect through policy instruments at the disposal of governments and societies. Absolute poverty also greatly influences vulnerability, lack of power, and the other dimensions of poverty.

Pro-poor growth is defined in this guide as growth that rapidly raises the absolute income of the poor by increasing the growth rate of the economy and the extent to which that growth benefits the poor. Since the criterion is the change in the absolute income of the poor, growth can be pro-poor even with a declining share of national income going to the poor, as long as growth is rapid enough. For example, overall per capita growth at 8 percent where the income of the poor rises by 7 percent is *more* pro-poor than overall per capita growth of 3 percent where the income of the poor increases by 5 percent. The goal of this guide, however, is to identify policies and programs that both speed the rate of growth and increase the share of the poor.

THE RELATIONSHIP BETWEEN THE RATE OF GROWTH AND POVERTY REDUCTION

There is no clear tendency for rapid growth to worsen income distribution. Therefore, the more rapid the growth, the greater the increase in the income of the poor in most cases. Rapid growth is usually necessary for poverty reduction in the medium and long terms. Indeed, if *per capita* growth is rapid enough—4 percent or better in the eight countries we studied—growth seems to be a sufficient condition for significant increases in the income of the poorest 40 percent.

Growth that is labor-intensive (growth that increases demand for the labor of the poor) will be especially pro-poor. Therefore, growth of labor-intensive sectors benefits the poor disproportionately. Historically these sectors have included agriculture; residential and some infrastructure construction; most trade and services; industries such as agricultural processing, garments, toys, shoes, and electronic goods; and a host of miscellaneous activities that grow rapidly if incentives are right but that differ among countries.

If growth does not create enough jobs to absorb the increases in the labor force, even high rates of growth leave the poor behind. If growth is concentrated in mining, forestry, and labor-displacing, capital- or technology-intensive industries, it can be rapid without much poverty reduction. Even growth in agriculture will not be poverty-reducing if it takes place mainly at the capital-intensive margin, as is happening in some South American countries. Where capital- or resource-intensive activities provide the initial dynamic for growth, poverty can still decline if these activities can generate enough income and government revenue to support rapid expansion of labor-intensive residential and infrastructure construction and the growth of supporting industries, trade, and services in a second round.

Even when the focus is on the absolute income of the poor, ignoring obvious increases in inequality can lead to political turmoil that can, in turn, result in further economic losses. Whether inequality leads to political problems depends on whether the inequality is visible and on what is happening to the income of the poor at the same time. Inequality is evident only if it takes the form of conspicuous consumption, and it is especially difficult to accept if the income of the poor is declining. Economically based riots therefore tend to occur during periods of economic decline if the conspicuous consumption of the rich continues unabated. Policy therefore should achieve both fast growth and a poverty-reducing, labor-intensive pattern of growth, a feat achieved in East and Southeast Asian countries and in a few countries elsewhere. The central goal of this guide is to identify such win–win policies.

MACROECONOMIC AND TRADE POLICY

Rapid, labor-intensive growth depends greatly on exchange-rate management and, to a lesser degree, on trade policy. An appropriate exchange rate allows countries to utilize their comparative advantage. In lower-income countries, that means exporting goods that use much labor and importing goods that require a lot of capital. If the exchange rate is overvalued, only well-established, traditional exports can compete in the world markets. But these are usually not dynamic, rapidly growing industries and do not create the new jobs that are essential to poverty-reducing growth. Rapid, pro-poor growth is facilitated by:

- Avoiding exchange-rate overvaluation, which would make it difficult for import-competing and nontraditional export activities to grow rapidly.

- Adopting a moderately undervalued currency of 15 percent to 20 percent (as indicated by accumulation of foreign-exchange reserves and a surplus on current account). Most countries successful in achieving rapid growth and poverty reduction have followed this practice. Such undervaluation helps cover the additional cost of breaking into world markets for industries and countries that are not well-established exporters. Acting as a small generalized subsidy, undervaluation avoids the need for government to try to pick winners and subsidize them specifically. Moreover, unlike specific subsidies, it is perfectly legal under all trade agreements.

- Reducing or eliminating export taxes and other unnecessary costs (such as those created by inefficient parastatal intermediaries), especially on labor-intensive, dynamic export products, and retaining them only on traditional exports during periods when they produce windfall profits (rents).

- Exempting exporters from import duties and taxes on inputs or compensating them for their costs. Although not easy to do, this is perfectly feasible.

- Making it attractive for foreigners to provide the access to technology and to markets required to break into new export lines. Usually that means an environment that is attractive for foreign investors, especially in the creation of new productive capacity.

- Dealing effectively with Dutch Disease problems, where exports are capital- or resource-intensive goods. In natural resource–rich countries, labor-intensive activities cannot compete in the world or with imports. It is therefore difficult to create the jobs and income needed currently to reduce poverty if the country is populous, or the jobs and income that will be needed when income from the oil or mineral exports declines. Solutions include imposing levies on traditional exports to finance growth in labor-intensive nontradables (such as housing) and creating a base for future growth in labor-intensive activities by funding appropriate education, training, and infrastructure development. Incentives for the production of labor-intensive tradables can be provided by a generalized subsidy via a currency that is undervalued for the current situation.

- Subjecting capital flows to enough control and taxes to limit the potential damage from rapid, short-term inflows or outflows, which can lead to macroeconomic and financial crisis.

In addition to fostering rapid, labor-intensive growth, macroeconomic policy needs to avoid hyperinflation or accelerating inflation, which hurts the poor disproportionately, by:

- Avoiding unsustainable budget deficits. This may require limiting subsidies that go to the nonpoor and strengthening tax collection.

- Limiting growth in the money supply, including taking steps to sterilize some of the accumulation of foreign-exchange reserves when this is likely to be temporary.

- Using self-targeting subsidies for foods consumed mostly by the poor to reduce the impact of inflation on them.

Tax and expenditure policies need to give government the resources required to provide education and health-care services to the poor; roads, power, and other infrastructure, especially for poorer areas; and services for family farms and small businesses that allow these labor-intensive activities to flourish.

EMPLOYMENT AND LABOR MARKET POLICIES

The key to pro-poor growth is to generate additional employment for the poor. Governments therefore face a policy dilemma and a difficult political choice: raising the minimum wage and strengthening labor protection laws help workers in the organized sectors but reduce employment for workers who cannot be effectively covered in the informal sectors. If the primary concern is raising the income of the poor, a reasonable set of policies is one that:

- Avoids trying to raise wages much, if at all, above market levels, which quickly becomes counterproductive. In response, employers shift to more capital-intensive methods and to other countries, use contract labor if it is exempt, and parcel out work to smaller subcontractors that are exempt. Employers that cannot escape such legislation may stop expanding.

- Concentrates on laws and rules that protect workers' health, safety, and right to organize, which can help workers at a reasonable cost to employers.

- Avoids subsidies to capital or machinery, often provided indirectly via lower interest rates or lower duties on machinery and by an overvalued currency, which make imported machinery cheap and domestic labor therefore relatively expensive.

- Stimulates employment by lowering the cost of labor to employers while benefiting workers through cost-of-living subsidies on bus fares, housing, health-care services, and basic foods. Such subsidies can be directed to workers in particular industries or to all the poor.

EDUCATION POLICY

Over the long term, education and training are central for promoting efficient growth and for increasing the human capital of the poor to bring them out of poverty. The rates of return on investing in the education of the poor tend to be substantial but vary greatly by type of investment and country. Promising areas include:

- Education for women often has higher returns because women have been given fewer educational opportunities than men in the past. It also yields indirect benefits through better education of children and fewer children.

- Access to basic education (which increasingly means at the secondary level).

- Improved educational quality.

- Use of incentives in the form of scholarships for students from poor families.

- Informal forms of education that, if well-done, are often cost-effective.

To determine which policies and expenditures are most cost-effective in terms of pro-poor growth, it is important to analyze their rates of return and to allow different suppliers—private, public, and cooperative—to compete.

HEALTH POLICY

The poor are severely disadvantaged in their health status. Focusing on the poor can therefore provide a high payoff. Health-sector priorities need to be reoriented to better reflect the contribution improved health can make to pro-poor economic growth through:

- Greater attention to health disorders that cause disabilities, such as mental disorders, injuries, blindness and other visual impairments, adult hearing loss, and osteoarthritis.

- Greater attention to investments that help avoid ruinous health expenditures by the poor, such as via subsidies to those health-care services whose costs can loom large in relation to the income of poor households.

- Targeted investments in related sectors, which can often have a greater impact on health than can direct health programs, through stabilized prices of basic foods, safer rural water and sanitation, rural roads, and improved environmental conditions.

HIV/AIDS has emerged as a key obstacle to some, especially African, countries' economic growth and poverty reduction because of its dramatically high incidence and concentration among the economically most productive age group. In currently low-prevalence countries, the spread of the disease must be slowed before it becomes entrenched in the general population. A committed national political leadership is always important, but it is pivotal in these countries. In high-prevalence countries, policy must focus AIDS prevention on sectors central to long-term development, such as education, health, and agriculture.

PRO-POOR FINANCE

Effective financial intermediation can contribute to faster and more pro-poor growth by lowering transactions costs on the transfer of funds from savers to investors, especially from low-income savers and to low-income investors. A pro-poor financial system should also channel funds efficiently to profitable small firms and farms that are labor-intensive and discourage the flow of credit to socially unproductive but politically powerful investors. Several types of policies can help achieve these outcomes:

- Prudent banking practices. These are especially important for the poor because the poor do not benefit from patronage-driven financial systems. Such practices include avoiding below-market interest rates, insisting on repayment of loans, and avoiding direct provision of credit by governments.

- Improved regulation and supervision of the financial system. This reduces the likelihood and costs of financial crises and bank failures. Helpful steps include bankruptcy procedures to deal with borrowers whose businesses fail and improvements to the legal framework such as effective collateralization laws.

- One-off subsidies for (1) training to raise the effectiveness of lending by commercial banks to small and medium-sized enterprises (SMEs); and (2) supporting the investment costs of expansion in underserved areas.

- Support for the establishment, expansion, and strengthening of sustainable microfinance programs (programs with repayment rates of 96 percent to 98 percent and market interest rates that more than cover all costs). This can help the poor by lowering their vulnerability to external shocks and by providing a base for the growth of household enterprises.

- Support for the expansion and improvement of savings facilities for low-income people, especially as part of microfinance programs.

AGRICULTURE AND RURAL POLICY

Because agriculture and the rural economy are generally labor-intensive when based on smallholders, the speed of the latter's growth is important for poverty reduction. But smallholders are less able than larger farms and firms to learn about new technologies and markets, to take the risk of adopting them, and to market their output. Government therefore has a larger role in agriculture than in sectors where the producing units are larger. However, government intervention must not distort incentives or compete with commercial operations; rather, it must supplement them. Specifically:

- Government needs to supplement private and international efforts in research, especially adaptive research. Targeted extension programs are also important.

- Temporary input subsidies can help speed the introduction of new technologies, but only if the inputs are made available to everyone and not subject to informal rationing. Otherwise scarce, subsidized inputs will go to the politically connected, not the poor.

- Subsidies to rural interest rates and mechanization programs need to be avoided.

- Agricultural development requires extensive investment in rural infrastructure. Market roads and irrigation are key, complemented by communications; electrification; and education, health, and market facilities. Urban bias in supplying infrastructure has been damaging to rural development in some countries at times.

- Public investment in irrigation remains important for agricultural productivity, lower risk, and diversification into higher-value crops. Private investment in local facilities can supplement major works but may benefit large farmers disproportionately.

- Taxing agriculture more than nonagriculture tends to hurt growth and the poor. So does exempting agriculture, or parts of it, from taxes that apply to the rest of the economy.

- Government-monopoly marketing agencies tend to evolve from agents for market stabilization to corrupt rent-seeking institutions with devastating impact on efficiency and poverty. At that point, their abolition can help the poor disproportionately.

- Using food aid as a substitute for domestic food production (except in clear humanitarian disasters) reduces incentives for domestic production unless demand is increased commensurately by using the proceeds to finance additional expenditures (such as those for labor-intensive construction).

- Supermarkets are becoming important in many countries. This can work to the disadvantage of small farmers and their labor-intensive methods of production unless they can be helped to meet the high standards on which supermarkets insist. This requires incentives for supermarkets to buy from smallholders or for private traders to take on the task of buying from smallholders and selling to supermarkets.

Targeted Programs and Safety Nets

Safety nets, or targeted programs, aim to reduce temporary shocks and the extremes in poverty generated in the market economy by natural catastrophes, economic setbacks, or inequalities in the ownership of productive assets. These programs can also mitigate the political and economic costs of a poverty reduction strategy based on rapid, market-driven growth that leaves behind some groups of the poor. Targeted interventions include cash and in-kind transfer programs, subsidies, and labor-intensive public works programs. The key challenge for these programs is to achieve effective targeting. Self-targeting tends to work best. Examples include subsidizing food eaten primarily by the poor, providing jobs at wages only the truly poor will accept, or limiting benefits to regions where almost everyone is poor. Four broad, overlapping types of targeted programs are particularly useful:

- **Labor-intensive public works programs** provide employment and increase the incomes of the poor while creating local infrastructure. Many projects can be justified on strictly economic efficiency grounds, especially in labor-abundant countries. Projects can also be readily expanded to form the centerpiece of social safety net programs. To benefit the poor, wages must be set below the prevailing level. Projects should be designed and executed locally. They are especially pro-poor where the poor play a large role in decision-making, as they increasingly do.

- **Price subsidies** lower the cost of goods and services the poor buy. By subsidizing low-quality goods or services that only the poor would want, the subsidies become self-targeting. Geographic targeting can also be effective, if there is a high regional concentration of poverty. In fact, many subsidies are for goods consumed by the middle class and become costly and inefficient but politically untouchable. They then actually hurt the poor because they take funds away from investment and growth.

- **Conditioned targeted programs** offer cash benefits to poor families, conditional on some socially desirable behavior, such as sending their children to school or making periodic visits to health-care clinics. These programs both raise the income of poor families and improve the future earnings potential of their children. A combination of geographic and locally applied means testing is the most effective way of targeting.

- **Social investment funds** give poor communities a large role in project selection and in funneling central government and donor funds directly to local entities for small-scale social and economic infrastructure subprojects in poor areas. Their primary purpose is the creation of local infrastructure. Unlike labor-intensive works, the emphasis is not on employment and direct income for the poor.

PRIVATIZATION

Privatization can play a role in pro-poor growth by raising the growth rate and by improving income distribution. Its efficiency effects are overwhelmingly positive and can be quantitatively substantial. The equity effects are less well-understood and far less uniform. The pace of privatization has recently slowed in most countries, in part because of the perception that the benefits have gone to the rich at the expense of the poor. Clearly, the impacts of privatization need to be better understood and the benefits better publicized.

POLICY TO ACHIEVE GENDER EQUITY

In many countries, women and women-headed households are disproportionately poor. A gender-equitable pro-poor growth strategy promotes economic opportunities for poor women. Promising areas include:

- Support for industries that provide employment primarily to women can provide a powerful boost to their income and social position and increase access to education of their children. Garment exports have played this role in many countries, as has temporary migration of women in a few countries. Support includes the next two items, as they apply to industrial areas.

- Investment in infrastructure, which helps to save women's time or improves the safety of those working outside the home (including local wells, better rural roads and paths, urban street lighting and police presence, and transport for multiple-shift women workers).

- Child-care subsidies to poor households or community-based child-care facilities.

- Improved access to capital through microcredit schemes and schemes for SME credit that emphasize loans to women. In countries with gender segregation, separate women's programs may be needed. Laws requiring married women to obtain spousal approval for bank loans should be removed.

- Social policies to promote female education and health, including increasing the number of schools where girls attend separate facilities.

- Labor legislation and other policies to reduce gender discrimination, where this can be applied without important offsetting effects (such as where equal-wage legislation leads to the firing of women). Effective use of such legislation calls for unusually well-designed laws and unusually good implementation.

POLICY IN POST-CONFLICT SETTINGS

Violent crises and civil wars inflict great human, social, and economic damage. Recent conflict has been concentrated in Africa, where the poverty challenge is also the largest and where many countries have fallen into a "poverty–conflict" trap. An effective initial response involves defusing current threats (for example, former combatants); stabilizing the situation; and beginning the process of reconciliation at the local level, crucial for community structures to become operational again. This effort should precede the ultimately central structural and macroeconomic policies needed for pro-poor growth. Usually, important steps include:

- Support for demobilized soldiers, refugees, and internally displaced persons;

- Labor-intensive rural infrastructure programs, implemented as quickly as possible, to get many people into productive employment and rebuild lost infrastructure; and

- Constant monitoring by administrators and donors, who must recognize that post-conflict reconstruction is much more complex and riskier than comparable activities in more stable environments.

POLICY TO PROTECT THE ENVIRONMENT

Poor families suffer disproportionately from environmental degradation. They also contribute substantially to such degradation through activities they are forced by poverty to engage in. A significant proportion of the poor live in marginal rural areas, and many of the urban poor are exposed to environmental threats to health. Among key policies to achieve growth that is both pro-poor and environmentally friendly are:

- Legal reforms to provide greater security to both community and private resource rights and to improve equitable access of the poor to the legal system;

- Improved capabilities of environmental protection agencies to carry out standard-setting, monitoring, enforcement, and public communications activities and of government agencies to manage natural resources;

- Tax reforms to improve the environmental sensitivity of tax design and administration (for example, avoiding de facto tax incentives to clear forestland, as in Brazil);

- Agricultural research and extension programs targeted to marginal and fragile lands; and

- Low-cost sanitation, water supply, and waste management programs targeted to low-income neighborhoods.

GOVERNANCE

Government plays a crucial role in pro-poor growth. Little progress can be made without at least the bare minimum of good economic governance, including a functioning government bureaucracy, a degree of civil order that permits investors to look beyond day-to-day security concerns, and some assurance that agreements and contracts will be honored. Rapid growth of foreign direct investment and international trade, however, will require more than meeting minimum conditions. More rapid economic growth is facilitated by:

- Transparency in government taxation and expenditure policies;
- Effective efforts to control corruption;
- Clear defense of the rule of law;
- A voice for multiple political constituencies; and, eventually,
- Competitive democratic processes as the basis for government formation.

Experience has shown that small groups of highly qualified and apolitical technocrats can have a major positive impact on the quality of public policy, most notably in macroeconomic policy, even in the midst of serious corruption and incompetence in much of public administration. Accordingly, support for developing groups of highly qualified technocrats should be a priority of international donors in many countries.

Even more important is support for reforms that reduce the burden on government and the opportunities for corruption, by moving from government controls to market incentives. In Indonesia, for instance, a shift from administered import licenses to a higher exchange rate to control the level of imports in one quick step eliminated probably the greatest source of distortions, inefficiency, and corruption in the economy.

CHAPTER ONE
WHAT IS POVERTY?

Poverty means many different things to different people. The term undoubtedly involves some form of unacceptable deprivation, but that is as far as the consensus goes. This chapter introduces the evolution of concepts and definitions of poverty and explains how poverty is defined for this guide. Distinguishing between concepts is important because the choice of poverty definition will significantly influence which policies and programs are more pro-poor than others. (A brief primer on poverty measurement questions can be found in Annex 3.)

FROM INCOME TO LIVELIHOODS VIA BASIC NEEDS AND CAPABILITIES

The usage of the word "poverty" has evolved a great deal in the past decade. It has expanded over time with the recognition that poverty is multidimensional. Early poverty definitions were narrowly focused on income. Today's broader definitions include income poverty as just one of a range of aspects of deprivation, all of which are interrelated. Poverty is seen as a dynamic, complex, institutionally embedded, and gender- and location-specific phenomenon. This major shift in thinking is reflected in the differences between the World Bank's seminal *World Development Report 1990: Poverty* and the *World Development Report 2000/2001: Attacking Poverty*. The first report focuses on income poverty. The latter paper, written a decade later, examines this dimension of poverty as well as three others: health and education, vulnerability, and voicelessness.

The following sections briefly summarize the evolution in thinking with regard to poverty.

Income Poverty

During the 1950s and 1960s, economic development was viewed as synonymous with increased national production. Poverty was the result of low gross domestic product (GDP) per capita. This period saw little attention being paid to income distribution or poverty per se; it was assumed that the benefits of modernization would eventually trickle down to all.

Basic Needs

A concern quickly arose that the expected trickle-down was not happening rapidly enough. The 1970s were thus marked by initial efforts to promote growth with equity, leading to targeted interventions focused on the poor, including integrated rural development and Women in Development (WID) programs. The basic-needs approach, introduced by the International Labour Organization (ILO), recognized that there are nonmonetary dimensions that influence whether people are poor, including lack of basic education, health care, and other services (such as water and sanitation).

Capabilities

By the 1980s, Amartya Sen was emphasizing that the value of income depends on the extent to which it increases the set of capabilities of individuals and thereby improves their functioning in society. Income is only one determinant of an individual's capability and functioning, so it cannot serve as a complete measure of well-being. This became the foundation of the United Nations Development Programme's (UNDP's) definition of human development as enlarging people's choices, and of poverty as deprivation of the most essential capabilities of life, including leading a long and healthy life, being knowledgeable, having adequate economic provisioning, and participating fully in the life of one's community.

Sustainable Livelihoods

In the 1990s, poverty moved to the center of the development agenda, as more participatory research began to highlight its multidimensional nature. Vulnerability was recognized as a key dimension, because the poor have fewer assets than the nonpoor to cushion against shocks, both natural and man-made (such as financial crises, conflicts, and natural disasters). Building on this concept, the United Kingdom's Department for International Development (DFID) pioneered the sustainable livelihoods framework, built on an asset pentagon comprising five types of capital that help keep people out of poverty:

- Human capital—skills, knowledge, health, and ability to work,
- Financial capital—earned income, remittances, savings, credit, and so on,
- Natural capital—access to land, forests, water, and clean air,
- Social capital—support networks of friends, family, and social organizations, and
- Physical capital—shelter, transport, water, energy, and communications.

ABSOLUTE OR RELATIVE? OBJECTIVE OR SUBJECTIVE? CHRONIC OR TRANSIENT?

Three additional distinctions are relevant to the definition of poverty: What does it mean when poverty is absolute or relative? How does the subjective approach differ from the objective? What distinguishes chronic from transient poverty?

- **Absolute poverty** means not being able to satisfy the minimum requirements for physical survival—food, clothing, and shelter. Absolute poverty thresholds are based on the cost of a basket of goods that satisfies these essential food and nonfood needs. The Millennium Development Goal for economic well-being is, by 2015, to reduce by half the number of people living in absolute poverty, as measured by the equivalent of one U.S. dollar per person per day. **Relative poverty** defines poverty in relation to either average levels or societal norms. A relative poverty line can be set as a fraction of the national average income, for example. The logic of this concept lies in the fact that people's sense of deprivation is often based on comparisons with others. Where inequality is high, many people do not have enough to meet what is viewed as a normal standard of living in that particular country. A lack of indoor plumbing or a telephone might be indicative of relative poverty in the United States but not in Sierra Leone.

- The **subjective poverty** approach to understanding deprivation holds that poverty must be defined by those experiencing poverty themselves and that meanings defined "from above" (for example, **objective poverty** measures in the absolute poverty tradition) are disempowering. The subjective poverty approach grew out of participatory rural appraisal methodologies and participatory poverty assessments, which sought to improve policymaking by incorporating local understanding and perceptions of poverty. Seminal work in this area is contained in the three-volume *Voices of the Poor* study.[1]

- The duration of poverty is important for the design of appropriate policy responses. The defining feature of **chronic poverty** is its extended duration. The chronically poor always live in poverty and have few assets or opportunities to escape it. **Transient poverty** is temporary or cyclical. The transient poor will move out of poverty once the exogenous shock has passed. Transient poverty might be related to seasonality or to losing one's job but having a good skill base to find another. The concepts of chronic and transient poverty pertain to the dynamics of poverty, recognizing that people and families may move in and out of the condition.

Poverty Definitions Have Policy Implications

The concept of poverty that is chosen for operational purposes is highly significant because it has direct implications for the poverty reduction strategies employed. Where absolute income is used as the poverty indicator, the central poverty reduction strategy becomes raising incomes of the poor through economic growth. The relative approach to poverty places greater importance on redistributive policies. When basic needs are emphasized, there is a larger role for public policy in the provision of health care, education, and other basic services for the poor. Where vulnerability is central to the poverty dynamic (and transient poverty is the main problem), the policy response must emphasize risk mitigation through social protection, such as social insurance and safety nets.

The progressive widening of the definition of poverty is sometimes represented graphically by a triangle, with income as the sole dimension at the top, gradually expanding to include other dimensions of well-being as one moves down the triangle (see Figure 1). First suggested by Baulch (1996) with slightly different content,[2] the pyramid of poverty concept illustrates an important trade-off between conceptual adequacy and practicality: The wider the definition of poverty, the richer and more meaningful it is, but the less practical it becomes to

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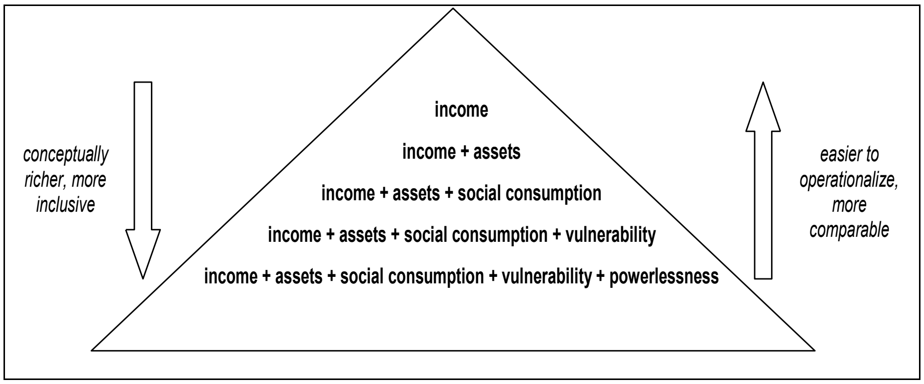
[1] *Voices of the Poor* consists of three books by Deepa Narayan et al.: *Can Anyone Hear Us?* (2000) gathers the voices of 40,000 poor men and women in 50 countries from the World Bank's participatory poverty assessments. *Crying Out for Change* (2000) is a 23-country comparative study. *From Many Lands* (2002) presents regional patterns and 14 country case studies.

[2] Baulch, Bob (1996). "Neglected Trade-Offs in Poverty Measurement," in *IDS Bulletin: Poverty, Policy and Aid*, 27 (1).

operationalize, and the more difficult it is to make quantitative comparisons. Policymakers and analysts must be aware of this trade-off.

Figure 1: A Pyramid of Poverty Concepts



A Definition of Poverty for the Pro-Poor Growth Research Studies

The basic mandate for the Pro-Poor Growth Research Studies project helped determine the poverty definition it used. The focus on pro-poor economic growth suggests absolute income as the core indicator of poverty. As alluded to above, income is a much more manageable concept to operationalize than the more complex multidimensional definitions of poverty shown in Figure 1. Income is also the central variable in absolute poverty, affecting most or all of the other factors that go into broader poverty definitions. That said, this guide includes discussions and policy guidance on nonmonetary aspects of deprivation, such as access to health care, basic education, and other services (see Chapter Four) and proposes policies and programs to reduce vulnerability through targeted programs (Chapter Five). The guide also considers cross-cutting poverty issues, including gender, the environment, and governance (Chapter Six).

Poverty Resources

For Further Reading

DFID (2001). *Poverty: Bridging the Gap (Guidance Notes)*, London: U.K. Department for International Development.

Hulme, David, Karen Moore, and Andrew Shepherd (2001). *Chronic Poverty: Meanings and Analytical Frameworks*, CPRC Working Paper 2, Manchester: IDPM.

Maxwell, Simon (1999). *The Meaning and Measurement of Poverty*, ODI Poverty Briefing No. 3, London: Overseas Development Institute.

Ravallion, Martin (2003). “The Debate on Globalization, Poverty and Inequality: Why Measurement Matters,” Policy Research Working Paper No. 3038, Washington, D.C.: The World Bank.

World Bank (2000). *World Development Report 2000/2001: Attacking Poverty*, Washington, D.C.: The World Bank.

Useful Web Sites

www.worldbank.org/poverty
PovertyNet is maintained by the World Bank’s Poverty Reduction Group, part of the Poverty Reduction and Economic Management Network. This comprehensive site contains a wealth of information and serves a range of users by providing both broad introductions to key issues with regard to poverty and detailed analyses and data for researchers and practitioners.

www.livelihoods.org
Livelihoods Connect is funded by DFID and maintained by the Institute of Development Studies, University of Sussex. The Web site synthesizes and organizes information relevant to DFID’s work on sustainable livelihoods. The “Information Resources” section contains guidance sheets, distance-learning materials, key documents, events, and organizational links.

www.chronicpoverty.org
The **Chronic Poverty Research Center** is an international partnership of universities, research institutes, and nongovernmental organizations established in 2000 with initial funding from DFID. Based at the Institute for Development Policy and Management, University of Manchester, the Web site includes poverty working papers, a research-methods toolbox, and a bibliographic database with 4,000 references as of September 2003.

CHAPTER TWO
WHAT IS PRO-POOR GROWTH?

When the focus is on income poverty, what matters most is how rapidly the incomes of the poor increase in absolute terms. That depends not only on how pro-poor the growth is but also on the overall or per capita growth rate. The degree to which growth is pro-poor can be defined by the elasticity of income growth among the poor in relation to the per capita income growth rate (referred to as "the elasticity of connection"). When overall growth is fast, it requires only a modest elasticity to significantly raise the absolute income of the poor. When overall growth is slow, acceptable growth in the absolute income of the poor requires that this elasticity be high. In several East Asian countries, especially Indonesia and China, the combination of very rapid aggregate growth and an elasticity of connection greater than one has led to the fastest and most massive reductions in poverty in history.

What happens to relative incomes is also important. If the income of the poor stagnates or falls but they can see all around them clear evidence that the income of the wealthier is rising, this tends to lead to anger and political instability, expressed in different societies in a range of ways, from the ballot box to riots and violence. The latter actions in turn hurt growth, resulting in a vicious cycle in which economic and political problems cause and reinforce each other.

IS RAPID ECONOMIC GROWTH NECESSARY OR SUFFICIENT FOR POVERTY REDUCTION?

If the aim of pro-poor growth is to increase the absolute income of the poor to raise as many as possible out of poverty, there are two ways of achieving this goal:

- By increasing average income in the country, or

- By helping the poor to obtain a larger share of national income—that is, by improving income distribution.

Policy options are complicated because the two elements are related. The rate of growth can be affected by income distribution, and income distribution can be affected by the policies pursued to raise the rate of growth. Complications notwithstanding, growth is generally good for the poor, for the following reasons:

1. The empirical record shows that a higher rate of growth benefits the poor. There is no clear tendency for faster growth to lead to a less-equal income distribution. If a higher rate of growth can be achieved without worsening income distribution, then, by definition, a higher rate of growth helps the poor emerge more quickly from poverty. Yet, faster growth achieved at the cost of a less-equal income distribution does not necessarily guarantee faster poverty reduction. The empirical record, however, shows that even in those cases where worsening income distribution has accompanied fast growth, the poor have generally benefited from that growth, as well. Deterioration of distribution, where it does occur, is seldom sharp enough to offset the positive impact of growth, provided that growth is reasonably fast. Indeed, high growth, on the order of 4 percent per capita in most countries, appears to be sufficient for poverty reduction. That rate of growth, even if it is not labor-intensive, results in a sufficient increase in the demand for labor to ensure that poverty declines. Economic growth therefore is a necessary condition for poverty reduction in most circumstances, and it is a sufficient condition if it is high enough.

Stagnation or decline in per capita incomes always hits the poor hard. This is confirmed by studies of Latin American countries during the crisis of the 1980s and by more recent analyses of the effects of the Asian and other economic crises of the 1990s. The country case studies of Peru, Ukraine, and Indonesia, included here on CD-ROM, report sharp increases in poverty when per capita income stagnates or falls. Declining incomes are usually disastrous for the poor.

Spotlight on: Brazil

The 1980s and early 1990s in **Brazil** exemplify the fact that poverty tends to rise more quickly in recession than it falls in subsequent recovery. Brazil suffered recessions in 1981–1983 and 1987–1991. When the country's post-recession recovery had brought per capita income back to its previous level, poverty was greater than at the beginning of the cycle.

2. There is no clear or general effect of the level of inequality on the rate of economic growth. Development specialists once thought that greater inequality facilitated a higher rate of growth because it led to greater savings (see *Pro-Poor Economic Growth: A Review of Recent Literature* on the enclosed CD-ROM). Subsequent analysis, however, has shown that there is no general relationship between inequality and the rate of growth. In fact, in some circumstances, inequality is clearly bad for growth.

3. The relationship between rate of growth and poverty reduction varies greatly among countries and over time. Although growth on average is definitely pro-poor, there are great differences across and within countries over time in the extent to which the poor benefit from a higher rate of growth. A central goal of this guide is to identify the circumstances that help the poor the most.

4. The key policy-related determinant of the extent to which economic growth benefits the poor is the labor intensity of that growth. The poor's access to assets (particularly, in many poor countries, to land) also greatly influences their incomes. Such access, however, does not change much unless there is a radical upheaval in the whole economic system. Over the long term, other variables also matter, including the spread of education and changes in the access of the poor to credit and informally acquired property. In the short term, the labor intensity of growth can change substantially, depending on the sectors and subsectors involved. That, in turn, is

Spotlight on: Uganda

Uganda's 1992 reforms increased economic efficiency and, supported by good prices for the country's principal export, were expansionary. Growth was led by labor-intensive peasant agriculture—first smallholder coffee growers, then food producers supplying the domestic market. The second phase, affecting food producers, was more powerful in reducing poverty because increases in income were more widely distributed among the poor.

substantially influenced by policies. Three key sectors are agriculture, construction, and labor-intensive manufacturing, often involving manufactured exports.

5. Significant improvements in income distribution through asset redistribution have been achieved only by a very few countries, except after major changes in the political system, changes that usually have their own costs. Therefore, we do not address the possibility of deliberate and major changes in income distribution through this mechanism as a policy tool to achieve more pro-poor growth.

6. Ignoring obvious increases in inequality, especially when they occur during periods of economic stagnation or decline, often has great political costs. These, in turn, can result in economic losses that hurt the poor. Our conclusion is that in virtually all countries and over periods of a decade or more, a healthy rate of growth is necessary for fast and sustained poverty reduction. Fast growth tends also to be sufficient to achieve at least a moderate rate of poverty reduction. It is also true, however, that the pattern of growth is an important determinant of the speed of poverty reduction with any given rate of growth, so the aim of policy should be to achieve both fast growth and a poverty-reducing pattern of growth. Under many circumstances, carefully designed policy can achieve both.

Spotlight on: Indonesia

In **Indonesia,** in the early to mid-1970s, growth was rapid but was concentrated in oil, mining, and timber, all highly capital-intensive, and in industries where machinery replaced labor in some processes. Per capita income increased by 4.4 percent per year, but the income of the poor stagnated. Growth was not pro-poor.

PRO-POOR, PRO-GROWTH, OR BOTH?

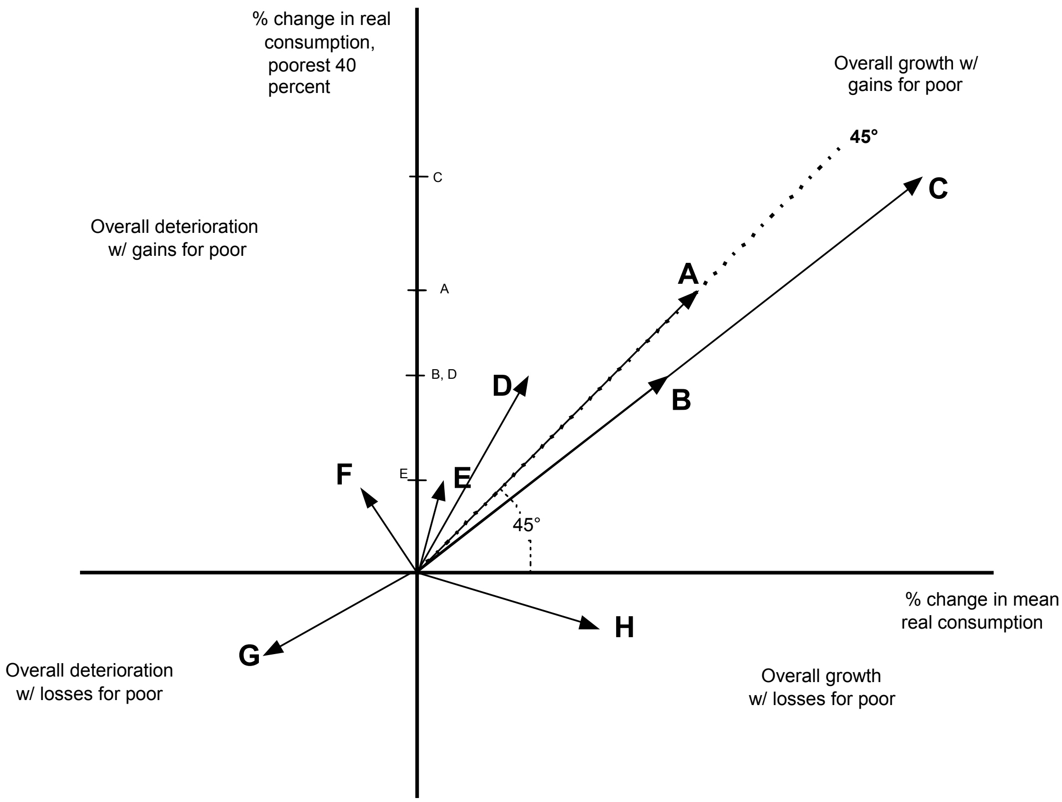
There is an important ambiguity in the phrase "pro-poor growth."[3] The phrase is widely taken to refer to any situation in which the incomes of the poor grow more quickly than those of all households—that is, where the distribution of income between the poor and the nonpoor becomes more equal as the economy grows. However, if the objective of a poverty reduction strategy is to increase the welfare of the poor, a growth strategy that is pro-poor in the above sense may be inferior to a strategy that produces a higher overall growth rate but does not involve disproportionate benefits to the poor. Recognizing this, some define pro-poor growth simply as growth that improves the welfare of the poor.

Figure 2 illustrates this point. The origin represents the initial conditions in a particular country at the outset of a growth episode of some duration. Each arrow represents two aspects of such a growth episode: the percentage change in aggregate national real consumption, measured along the horizontal axis, and the percentage change in the real

[3] This section and Figure 2 draw heavily on an unpublished paper by Don Sillers, which he has kindly permitted us to use here.

consumption of the poorest 40 percent of households, measured along the vertical axis.[4] The northeast and southwest quadrants represent the overwhelming majority of real-world experience, as documented by Deininger and Squire[5] and others: overall growth accompanied by growth in the consumption of the poor and overall economic deterioration accompanied by further immiserization of the poor. The empirical record demonstrates that the consumption of the poor only rarely moves in a different direction from national consumption. As a result, it is reasonable to concentrate on the northeast quadrant, where virtually all episodes of overall growth that benefit the poor are plotted.

Figure 2: Two Concepts of Pro-Poor Growth



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4 The poorest 40 percent are highlighted purely for the sake of specificity; attention could equally be drawn to the poorest 10 percent or 20 percent, or to those households initially living under the $1-a-day or $2-a-day poverty lines. In poor countries, mostly in Africa and South Asia, the poorest 40 percent are all absolutely poor by world standards and an appropriate focus for attention. In middle-income countries, mostly in South America, the poorest 20 percent fall in the category of absolute poor and are often the focus of policy and program attention. The poorest 10 percent in most countries can be considered the poorest of the poor. To reach them may be more difficult; most cannot be helped by policies that work through the labor market because they may have no family members who can hold regular jobs and they can be helped only by welfare measures. Our focus is not on the poorest, but on the much larger group that has at least one income earner.

5 Deininger, Klaus, and Lyn Squire (1996). "A New Data Set Measuring Income Inequality," in *The World Bank Economic Review,* September 1996, 10(3), pp. 565-591. Data also available at www. worldbank.org/html/prdmg/grwthweb/growth_t.htm.

Growth with unchanged distribution is represented by an arrow lying along the 45-degree line. All arrows lying above this line (such as arrows D and E in Figure 2) represent pro-poor growth under either definition of this term: not only has the consumption of the poor increased, as required by the outcomes-centered definition—it has increased *proportionately more* than the national average, as required by the distribution-centered definition. In contrast, growth episodes represented by arrows at or below the 45-degree line (such as A, B, and C) may be counted as pro-poor or not, depending on the definition applied. Under the outcome-centered definition, all such growth episodes are pro-poor: the increased consumption of poor households is the only thing that matters. In contrast, under the distribution-centered definition, these episodes would be described as trickle-down or pro-rich or anti-poor, regardless of how well the poor do over the corresponding growth episode.

By extension, one can rank growth strategies in two different ways: by how quickly the consumption of the poor rises relative to everyone else (how far above or below the 45-degree line the growth trajectory is) or by how quickly the consumption of the poor rises in and of itself (the vertical component of the arrow representing the growth strategy). According to the first criterion, the growth strategy that reaches point E is more pro-poor than one that reaches point B: at point E the consumption of the poor grows more quickly than the overall average, whereas at point B it grows more slowly than the average. In contrast, for those interested in the welfare of the poor, B is preferable to E.

In conclusion, growth strategies should not be ranked by how quickly the relative incomes or consumption of the poor increases. Rather, one should pay most attention to growth in the absolute consumption of poor households. The goal of pro-poor growth strategies as defined in this guide is to increase the welfare of the poor by increasing the growth rate of the overall economy, as well as by increasing the extent to which that growth rate benefits the poor (by rotating the growth arrow for the economy in Figure 2 in a counterclockwise direction).

PRO-POOR GROWTH RESOURCES

For Further Reading

Chen, Shaohua, and Martin Ravallion (2001). *Measuring Pro-Poor Growth*, Policy Research Working Paper No. 2666, Washington, D.C.: The World Bank.

Development Alternatives, Inc., (DAI) and Boston Institute for Developing Economies (BIDE) (2002). *Pro-Poor Economic Growth: A Review of Recent Literature,* Deliverable 3, USAID Pro-Poor Economic Growth Research Studies and Guidance Manual Activity, Bethesda, Md.: DAI and BIDE.

Dollar, David, and Art Kraay (2001). *Growth Is Good for the Poor*, Policy Research Working Paper No. 2587, Washington, D.C.: The World Bank.

Kakwani, Nanak, and Ernesto Pernia (2000). "What Is Pro-Poor Growth?" in *Asian Development Review*, 18(1).

Useful Web Sites

http://econ.worldbank.org/programs/poverty/topic/2543
This **World Bank Poverty Research Program** Web site houses the "Pro-Poor Growth" subtopic. Looking Beyond Averages: A Poverty Research Program is managed by Martin Ravallion. This subtopic site includes discussion of pro-poor growth and a selection of documents and research papers from the Pro-Poor Growth library.

www.adb.org/poverty
The **Asian Development Bank** portal for poverty reduction policies, strategies, and activities. The ADB Poverty Reduction Strategy is based on three pillars: pro-poor growth, social development, and good governance. This site also includes a link to all papers presented at the Asia-Pacific Poverty Forum in February 2001.

www.asiapropoor.net
This is the Web site of the UNDP's regional program **The Macroeconomics of Poverty Reduction**, designed to build on the lessons from the South Asia Poverty Alleviation Program and other major national poverty reduction programs across the Asia-Pacific region over the past decade. It seeks to identify growth-oriented stabilization policies and pro-poor adjustment policies. The assessment component of the program seeks to develop workable systems that will help countries link reported trends in poverty to the impact of national policies and strategies. During the first phase of operation (2002 to 2003), this initiative covers nine countries: Bangladesh, Cambodia, China, Indonesia, Mongolia, Myanmar, Nepal, Sri Lanka, and Vietnam. Based on the results of this phase and the availability of funds, additional countries will be included in a second phase, in 2004 to 2005.

CHAPTER THREE
THE BROAD POLICY SETTING

Rapid economic growth is built on a combination of good macroeconomic and microeconomic policies. Macroeconomic policies, including monetary, fiscal, and exchange-rate policies, maintain overall external and internal balance to avoid shortages of foreign exchange and excessive inflation. Microeconomic policies improve the productivity of the firms and industries that make up the economy. Higher productivity, defined as a better ratio of outputs to inputs, reflects improved performance of both firm-level production and interfirm transactions. Other things being equal, higher productivity implies a better capacity to compete, whether with other firms, with groups of firms, or with other countries.

There is basic complementarity between micro- and macroeconomic policy. Good microeconomic policy raises the productive potential of the economy, while good macroeconomic policy ensures that actual economic performance lives up to that potential. High real interest rates or restrictive monetary and fiscal policies that lead to resource underutilization are ways that an economy can fail to reach its potential. Another is by failing to take full advantage of productive potential in tradables by overvaluing the exchange rate. At this very general level of discussion, macroeconomic and microeconomic policies are fully complementary. The better each set of policies is, the more successful the economy's performance will be. In some settings, however, the relationship between the two is more complicated.

This chapter first explores the interaction of microeconomic and macroeconomic policies. The second section discusses and provides recommendations with regard to macroeconomic and trade policies. The last part of the chapter assesses pro-poor labor and employment policies.

THE INTERACTION OF MICROECONOMIC AND MACROECONOMIC POLICIES

In some cases, microeconomic policies may substitute in part for macroeconomic policies. Usually this happens when there are political or administrative reasons why macroeconomic policies cannot be changed in such a way as to achieve their objectives. A typical case would be a country running a balance-of-payments deficit and needing to increase its competitiveness in the world market. To achieve this, it can:

- Use macroeconomic policy to devalue its currency, thereby lowering the international price of nontradable factors of production, especially labor;[6]
- Use microeconomic policy to increase the productivity of the factors of production, to increase the efficiency with which the economy uses its labor and capital; or

[6] Lowering the nominal wage rate and the nominal prices of other non-tradable factors is a less palatable and hence rarely attempted way to achieve the same objective.

- Lower some other costs directly; for instance, by fighting corruption and decreasing the rents exacted from producers by government officials.

If the country is dealing with a serious imbalance, it may have to use all three methods. The appropriate combination of macro and micro policies depends on the context, especially the degree of imbalance that needs to be addressed and the time frame within which results are needed. One must also assess their relative strengths and weaknesses vis-à-vis the attainment of the objectives. Thus, devaluation and other macroeconomic policy measures can create problems of their own. Often countries have preferred not to use devaluation because it would contribute to inflation. Devaluation works by reducing real wages and the compensation of other nontradable factors, at least in the short term, and thus imposes costs on workers, some of whom are among the poor. On the other hand, increasing efficiency and lowering costs of corruption benefit the economy as a whole at no costs to vulnerable groups. So it is preferable to use microeconomic reforms to the maximum extent possible.

Microeconomic policies have their own limitations, however. While devaluation can increase competitiveness by 20 percent or even 50 percent within a matter of months, raising efficiency (or total factor productivity, in the jargon of economists) can be a slow process. Increases rarely exceed 3 percent to 4 percent per year in any economy, and are more normally in the 1-percent to 3-percent range for the economy as a whole, although they could be somewhat greater in tradables or any other segment of the economy. To increase competitiveness by even 20 percent through microeconomic policies is therefore typically a task requiring 10 years or more, even assuming a lot of hard work. Indeed, in some economies efficiency has declined, not increased, for periods of years, with all growth due to investment and a growing labor force. Lowering domestic factor costs is equally difficult and time-consuming. Some countries have been trying to reduce the cost of corruption for years with only limited success.

There are also times when microeconomic reforms can produce large benefits in a short period. A major reform push, which usually comes with a change in government and in the political landscape, can quickly increase the efficiency of the economy and the institutions that affect the cost of some nontradables. Major changes in a culture of corruption can sometimes be brought about in short order by determined leadership (see Chapter Seven and the Peru country case study). Shifting from an inefficient import management system to a market-driven system can eliminate a major source of inefficiency and losses due to corruption (see Chapter Seven and the Sri Lanka case study). Changes in fertilizer prices and in marketing practices can result in a spurt in agricultural production that requires little or no new investment (see Chapter Seven and the Uganda and Indonesia case studies). Usually, reform packages combine all three approaches, with macroeconomic policy changes, microeconomic policy changes, and institutional reforms all reinforcing each other.

The key determinant of the appropriate choice of options is the degree of existing imbalance in need of correction. A country seeking a 40-percent improvement in competitiveness vis-à-vis other countries could not hope to achieve it in the short run (of, say, five years) through productivity policy alone. A sufficiently dramatic lowering of domestic factor prices, mainly wages, is usually infeasible politically. In cases where current inefficiency or corruption is very high, improvements on that front can go a long way toward meeting the challenge, but this requires both that the inefficiencies be very large and that their quick reduction be possible. Thus, the normal recourse in cases of large imbalance would be devaluation, complemented in varying degrees by microtype policies.

Improvements in productivity and competitiveness are the basic long-run source of economic growth and welfare improvement, and good microeconomic policies make their main contribution by furthering this long-run process. Good macroeconomic policies complement but cannot substitute for them in this role. Under most circumstances, the principal weapons in the economist's short- and medium-term policy arsenal are macroeconomic policies. Microeconomic policy and institutional change can reinforce them, but usually cannot substitute for them. Partly for that reason, and partly because a comprehensive volume has recently been published on competitiveness,[7] an important aspect of microeconomic policy, this guide concentrates primarily on macroeconomic policies and pro-poor growth. It does, however, include extensive discussions of microeconomic issues in the context of such key sectors as agriculture, education, and finance.

Both macroeconomic and microeconomic policies can be more or less pro-poor. It is therefore necessary to use effective pro-poor policy in both areas in pursuit of rapid pro-poor growth. For instance, raising the productivity and competitiveness of small companies is normally more pro-poor than is raising the productivity of large, capital-intensive firms. Further, macroeconomic policy that avoids serious recessions is normally pro-poor because of the greater vulnerability of the poor to such recessions.

MACROECONOMIC AND TRADE POLICY

Macroeconomic policy (on the exchange rate, taxes and government expenditures, inflation, and interest rates), together with trade policy, sets the stage for strong, stable growth and affects how much growth benefits the poor. On the fiscal side, it is important that taxes not fall too heavily on the poor. On the expenditure side, investments in infrastructure and education and health should be pro-poor. Monetary policy affects the allocation of credit to the poor and determines the relative returns to the financial assets they hold, but it is the success of overall macroeconomic policy in achieving a high rate of growth and avoiding severe economic dislocations that is most important to the poor, because they gain, sometimes more than proportionately, from high rates of growth and suffer disproportionately from economic downturns and from very high or accelerating rates of inflation.

[7] DAI (2003). "Competitiveness: That Obscure Object of Desire," from *Developing Alternatives*, Winter 2003, 9(1). This edited volume reviews evidence on such key aspects of competitiveness in developing countries as cluster formation, governance of value chains, and dealing effectively with competitiveness issues in institutionally inhospitable settings.

The Exchange Rate: A Key Macroeconomic Variable

The exchange rate and barriers or inducements to trade and capital flows have an especially large impact on the poor through their effects on growth and the labor-intensity of growth. The real exchange rate is a key determinant of whether growth is led by the traded- or the nontraded-goods sectors. Which of these alternatives is more pro-poor depends on which sector, traded or nontraded, requires more unskilled labor. Countries differ in this regard and so, therefore, does the relationship between the exchange rate and the demand for unskilled labor. In the so-called Dutch Disease economies, most exports are natural resources, produced with relatively little unskilled labor. In such economies, most unskilled labor is in the nontraded-goods sectors. Here, currency appreciation helps unskilled labor and is favorable to the poor, provided the income from natural resource exports continues for a substantial period. In countries where tradables come primarily from labor-intensive agriculture or manufacturing, appreciation is likely to hurt the poor.

Exchange-rate policy must be framed against an understanding of its function in maintaining the long-run balance of payments equilibrium. This imposes limits on exchange-rate manipulation. The exchange rate cannot be kept overvalued in the long run without simultaneous imposition of controls on trade (such as tariffs or exchange controls designed to limit the expenditure of foreign exchange). Without limits on imports, an overvalued exchange rate can continue only while the country has foreign-exchange reserves or borrowing capacity it can use to fund the gap between declining exports and rising imports, which are typical of an overvalued exchange rate. Therefore, a high or rising real exchange rate can bring only temporary pro-poor benefits. An overvalued exchange rate can be pro-poor as long as it can be maintained because it reduces the cost of such imports as the food consumed by the poor and stimulates production of labor-intensive nontradables, such as residential construction. If, however, the overvaluation is not ended before the country's foreign exchange runs out, the country will face a foreign-exchange crisis through a sharp reduction in spending, which usually hits the poor hard.

The exchange rate can, however, be kept *under*valued for long periods, as long as the country can cope with the macroeconomic effects of the resulting buildup of foreign exchange. In cases where a low or falling real exchange rate has pro-poor effects because of the labor intensity of tradables, such benefits can be achieved for both the long and short terms. A country can accumulate foreign exchange for 20 years or longer, as did Korea, Taiwan, and China and, to a lesser extent, Indonesia.

Spotlight on: Uganda

Uganda during the 1990s recovery is an example of successful exchange-rate management in an economy that continued to rely on agricultural production as its mainstay. A favorable floating exchange rate, part of its successful structural adjustment program of the 1990s, facilitated Uganda's recapture of a share of the coffee market, which it had lost during the period of civil strife and mismanagement.

It is thus crucial to note changes in the real exchange rate that result from temporary conditions such as a spike in oil or copper prices or temporary capital inflows. As the real exchange rate appreciates temporarily, the traded-goods sector and its employees will be hurt, as imports flood in and exporters find it difficult to compete in the world market.

Appreciation will, however, help the nontraded-goods sector, because the price of imported inputs and consumer goods is kept low. Whether that helps or hurts the poor in any particular economy depends on the nature of its traded-goods sector: is it closer to the natural resource case or the manufacturing–agriculture case? In either case, policymakers must remember that these changes are temporary. In the long run, the real exchange rate must be at a level that achieves balance-of-payments equilibrium and thus avoids an unacceptable buildup of foreign debt, and the exchange rate and the real wage for unskilled labor must adjust to the structure and productivity of the economy. In natural resource economies, most employment of unskilled labor will be in the nontraded-goods sector. As long as that sector enjoys strong demand, these laborers will not be harmed by the high real exchange rate brought on by such a productive structure. Indeed, workers may be helped if the high real exchange rate ensures cheap imported food and other goods they buy. A problem arises, however, when the export of the natural resource no longer generates enough income to employ all the poor.

The opposite occurs in economies with large manufacturing and agriculture sectors that employ most of the unskilled labor. An overvalued exchange rate there reduces the competitiveness of the goods the poor produce and makes it difficult to expand their production to provide employment at increasing real wages to the poor.

Complicating the effective management of the real exchange rate is the fact that the medium- or long-run equilibrium rate is not known in advance and that short-term changes can be large. The prediction of future equilibrium rates is difficult in a world where the prices and quantities of traded goods and services are volatile; it is harder still when there are huge capital flows with no easy way to know which movements will turn out to be permanent and which will be transitory. It is hardest of all to predict when a long-term change is coming to an end and adjustments must be made to anticipate the end and avoid a serious crisis. When market forces lead to an exchange-rate appreciation, they may be guiding that rate to a new long-run equilibrium level, if the appreciation is the result of a long-term capital inflow or higher domestic productivity. Alternately, market forces may be producing an overvalued exchange rate. In the former case, the country has to design an incentive structure such that the capital inflow will be used in a pro-poor employment-creating way. In the latter case, the country must try to counteract the damping effect of the appreciation on the production of tradables to prepare for the day when the capital inflow will stop or be reversed and a healthy tradables sector will again be essential to economic growth.

Given this uncertainty, it is useful to examine country experience of the past 50 years in framing exchange-rate policies. Most of the success stories—countries that have achieved significant poverty reduction and major increases in the income of their poor—have used an undervalued exchange rate, which has helped in attaining a high rate of growth and in ensuring that growth is concentrated in labor-intensive sectors. A few countries have successfully used an overvalued exchange rate to provide temporary benefits to their poor, but many more have kept their rate overvalued too long. Faced with the equivalent of bankruptcy, they have found themselves in a balance-of-payments crisis that has had a serious impact on the poor. There are hardly any examples of countries that correctly anticipated that a temporary overvaluation was about to end, and there are far too many examples of delaying devaluation beyond the point of prudence, at cost to both growth and the poor.

International Trade

> **Spotlight on: Zambia**
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> **Zambia's** experience with trade liberalization calls into question the wisdom of failing to maintain some protection in the context of an appreciating and ultimately overvalued exchange rate and of having trading partners that do not comply with trade agreements. The total removal of protection as part of the country's early 1990s structural adjustment program hurt the competitiveness of Zambian exporters. Trade policy, like other important policies, should not be made or implemented in isolation.

International trade can provide benefits to all countries, but the magnitude of the benefits depends on the strength of the country's comparative advantages. If the country's competitive position is concentrated in labor-intensive goods and services, both the growth and the distributional impact of trade are likely to contribute to poverty reduction. Where the comparative advantage lies in capital- or resource-intensive goods (such as mining or agricultural goods produced in capital- or land-intensive ways), the growth benefits may be substantial but the poverty effects may not be, unless policy is carefully designed to use the gains from export activities to create productive employment in other areas. The empirical evidence is ambiguous on whether the typical developing country would gain from moving further toward free trade, which suggests that some countries would benefit and others would not, depending on their structures, location, current degree of openness, and the policies that are feasible in the country. While it is true that the Asian success stories involved economies that moved increasingly toward free trade, they did so over time and with careful attention to sequencing. They furthermore did so during early stages of development. Latin American and African countries have different economic structures and international environment and face a different set of circumstances.

International Investment

> **Spotlight on: Sri Lanka**
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> **Sri Lanka's** garment industry, a large contributor to the success in reducing poverty among the country's women, depended heavily on foreign direct investment in its initial development.

Like trade, international investment is much more beneficial to developing countries in some situations than in others. Usually, the most desirable form is foreign direct investment (FDI), which creates new productive capacity (rather than buying existing capacity), with a net inflow of capital at least as great as the FDI itself. Ideally, FDI would create a large number of jobs, not displace domestic firms; would achieve international competitiveness if producing tradables; and would generate positive externalities for other firms through technological transfer or through input and output linkages.

International capital movements other than FDI, which have been greatly liberalized over the past couple of decades, bring serious problems and challenges along with benefits, because of the risk that the capital will move out again on short notice. In particular, short-term capital flows (or “hot money”) have the potential to greatly complicate the management of both trade policy and macroeconomic policy and have been the main source of numerous financial crises over the past decade. To lower the likelihood of severe economic downturns, countries need to find ways to curtail such capital volatility, whether through controls or taxes on capital flows or by strengthening the capacity of their financial systems to deal with such short-term movements.

This guide addresses only those macroeconomic and trade policy tools that are key to pro-poor growth. Given the importance of growth to poverty reduction, the effective management of macroeconomic/trade/exchange-rate/foreign investment policies is clearly important for their growth effects alone. Avoiding macroeconomic recessions is also extremely important to the poor because recessions tend to be doubly damaging. A worsening distribution of income often accompanies the loss of output, and poverty almost inevitably rises. Finally, trade-related policies can also have a large impact on the labor intensity of growth and are therefore important determinants of the extent to which growth is pro-poor.

Macroeconomic and Trade Policy Recommendations

Well-designed macroeconomic policies are key to rapid pro-poor growth and sustained poverty reduction. Because the poor derive most of their income from labor, increasing demand for labor is the key to pro-poor growth. Pro-poor growth thus requires policies that provide incentives to labor intensity.

1. Avoid exchange-rate overvaluations, which make it difficult for import-competing and nontraditional export activities to grow rapidly. In economies with large traded-goods sectors in labor-intensive manufacturing and/or agriculture, it is important to avoid even temporary exchange-rate overvaluations, which may occur because of temporary capital inflows or because the exchange rate is used as a way of controlling inflation. In either case, the traded-goods sector and its unskilled labor will be hurt in the short run.

2. Adopt a moderate currency undervaluation of 15 percent to 20 percent. Most countries that have been successful in achieving rapid growth and substantial poverty reduction have followed this practice, indicated by accumulating foreign-exchange reserves and a surplus on current account. Such undervaluation helps cover the additional cost of breaking into world markets for industries and countries that are not well-established exporters in a particular line. Acting as a small generalized subsidy, this practice avoids the need for governments to try to pick “winners” and subsidize them specifically. Moreover, unlike specific subsidies, the undervaluation practice is perfectly legal under all trade agreements. Mild undervaluation can have considerable benefits for the poor (see Chapter Seven and the country case studies of Indonesia, Egypt, and Peru).

3. Avoid excessive fluctuation of the real exchange rate. Temporary fluctuations in the real exchange rate are costly, regardless of the structure of the economy and whether the traded-goods sector is based mainly on natural resources or on unskilled labor. They cause temporary and wasteful contractions and bankruptcies in sectors that may well be competitive in the long run. Temporary fluctuations in relative prices always have significant real costs to the poor and to others. To reduce these fluctuations, some sort on controls of short-run capital may be necessary.

4. Subject capital flows to enough controls and taxes so as to limit potential damage from rapid outflows leading to macroeconomic and financial crisis. Given the magnitude of short-term capital flows in the present world economy, it is difficult for most countries to cope with sudden, sharp, and massive capital outflows, which can precipitate a fall of 10 percent or more in national income (see the Peru and Indonesia country case studies). Compensating for them would require massive foreign-exchange reserves, which have costs of their own. At the same time, it is important for most countries that want a high rate of growth not to discourage desirable long-term inflows of capital that can contribute powerfully to growth and efficiency. Policies to limit rapid outflows therefore need to be well-designed to encourage foreign investment while discouraging sudden, rapid outflows. First, there should be no outright prohibitions on capital movements and no licensing system in which an official determines whether capital is long-term or short-term. Both of these practices discourage foreign inflows. Second, the system needs to be flexible. Third, investors need firm assurances that they can take their capital out, provided they meet the rules the country has adopted.

One approach that meets these requirements is a system of taxes with high rates for capital that moves in and out after days, weeks, or a few months; low rates for capital that remains in the country for several months; zero taxes on capital that has remained in the country for a year or longer; and other possible penalties for very short-term movements.

Some countries seem to have managed such a system fairly well, with Chile and Malaysia as examples. Countries with a particularly weak civil service, and suffering especially from corruption, may not have the administrative capacity to manage such a system without discouraging foreign private investment. In that case, forgoing controls may be necessary (see the Indonesia country case study). An additional limitation is that controls cannot work if they are imposed when a country's currency is significantly overvalued. In that case, the incentives for taking money out become too strong.

5. Provide special incentives for and remove barriers to labor-intensive exports and import substitutes. The main pro-poor benefits from trade are that it can provide incentives for the production of labor-intensive items to be sold in a world market that is huge for most countries and products. To realize these benefits, it is desirable to:

> **Spotlight on: Brazil**
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> **Brazil's** 1985 tariff structure was particularly harmful to rural families and to the urban unskilled. Trade liberalization between 1988 and 1994 lowered inequality, increased output, and lowered poverty.

- **Reduce or eliminate export taxes,** especially on labor-intensive, dynamic export products, retaining the taxes only selectively on traditional exports during periods when they produce windfall profits (rents). Export taxes are particularly inappropriate for labor-intensive, nontraditional goods, but sometimes they are also a major obstacle to the export of minor, labor-intensive agricultural crops with a dynamic growth potential, such as cut flowers or fresh fruit.

- **Remove public or private monopolies** on the trade of such goods to maximize the benefits of such trade (see the country case studies for Uganda and Indonesia).

- **Develop policies to compensate for tariffs or other protective measures on imports that are used as inputs in labor-intensive industries.** Some countries impose tariffs or other measures to foster selected industries, thus raising the cost of imported goods subject to protective measures. Such countries then need to develop, to the maximum extent administratively feasible, measures to offset the cost-raising effects of protectionism on the production of labor-intensive exports, especially exports that use significant amounts of imported inputs. These compensatory measures can include bonded warehouses, export processing zones free of import tariffs and restrictions, and drawback schemes. The last can be especially useful if they are widely applied and essentially automatic, so that the exporter is sure of getting them fully and quickly without having to pay a bribe.

- **Provide incentives, especially through the exchange rate, for nontraditional labor-intensive exports.** These incentives are particularly beneficial when an economy is in recession and idle labor and capital can be put to work. A slightly undervalued currency can be especially helpful at such a time (see the country case study of Peru).

6. Make it attractive for foreigners to provide the access to the technology and the markets required to break into new export lines, especially for labor-intensive exports. Providing an environment that is attractive for all investors is the most important step toward attracting foreign investors. This calls for some assurances against the excessive risk of an unstable political or security situation, which includes the security of an honest judicial system and the likelihood of a reasonable return given the risk. Governments need to recognize that the greater the risk and uncertainty, the greater the potential return has to be to make it worthwhile for an investor to invest. In practice, it is difficult to defend high profits politically, even if they are justified by the risky environment of the particular country involved. The rate of return depends partly on factors not amenable to policy change, such as the terms of trade and the natural resource endowment. Primarily under the control of a government is the policy environment, already discussed. In addition to policies that matter to all investors, foreign investors are concerned with governmental attitudes toward them and the tax regime they face.

The most successful governments have been those that calibrate policies to give the greatest incentives to the foreign investor who makes the greatest contribution to pro-poor growth by:

- Investing in the creation of new productive capacity, sometimes called "greenfields" investment, rather than buying existing firms or buying bonds or stocks;
- Bringing in its own capital, rather than borrowing domestically;

- Bringing in new but appropriate technology, developing new industries, breaking into a new market, or otherwise improving the country's competitive situation;
- Stimulating related investment; and
- Developing labor-intensive activities.

Both the growth and distributional impacts of FDI can vary widely, so a selective approach is needed that reasonably automatically provides the greatest incentives to those investors making the greatest contribution.

7. Deal effectively with Dutch Disease problems by providing incentives for activities that are not competitive at the exchange rate generated by current resource-based exports. Dutch Disease is a problem in countries whose traditional exports are resource- and/or capital-intensive. These traditional exports are inadequate to employ a growing population (see the Zambia, Peru, Indonesia, and Egypt country case studies). New exports or import substitutes need to be developed over time as the population increases and/or the resource is used up. If not, a balance-of-payments problem will develop.

Resource-based exports are subject to wide fluctuations in price, which means feast-or-famine situations with respect to foreign-exchange availability. The government involved needs to deal with these problems of economic management. Windfall gains from the exports should be taxed to fund temporary increases in such nontradable activities as the building of schools to expand the educational system; construction of housing, especially for poor groups; and local, small infrastructure projects. If all these activities are labor-intensive, their impact on import demand can be reduced and they will also help to reduce poverty.

Over the long term, the government will need to use taxes and profits from these exports to finance growth in these or other labor-intensive nontradables. It should also create a base for future growth in more labor-intensive activities by funding appropriate education, training, and infrastructure. Most importantly for the long term, policy needs to encourage the development of activities in industry and agriculture that can provide jobs and income to a growing population, and to substitute for declining per capita natural resources. The most efficient way to do so is to use a generalized subsidy via a currency that is undervalued for the current situation.

Spotlight on: Peru

Exchange-rate management in **Peru** has had to contend with Dutch Disease problems: the mining sector, which is capital- and skill-intensive, has usually dominated exports. It is competitive at an exchange rate at which many labor-intensive sectors cannot export or compete with imports. One interesting option would have been to have raised incentives for output and export growth in manufacturing, nontraditional agriculture, and modern services by maintaining an undervalued exchange rate at least for a period of time.

8. Tailor structural adjustment to minimize its costs to the poor. Utilization of foreign aid can help countries do this. Structural adjustment policies may sometimes be necessary to correct an unsustainable balance-of-payments deficit. Yet the poor are usually hit hard by such policies. Uganda in the 1990s and Indonesia in the 1960s were both relatively successful in designing a structural adjustment program that did not unduly hurt the poor.

Both countries received substantial foreign aid, which helps achieve expansionary adjustment rather than the contractionary adjustment that has become the norm. In both countries, substantial aid was critical, permitting an increase in both investment and private consumption and helping to reduce poverty. Both Indonesia and Uganda also used the exchange rate and reduced controls to obtain a quick increase in agricultural production and exports. The story of structural adjustment in Zambia is decidedly more mixed (see the Uganda, Egypt, Indonesia, and Zambia country studies).

9. Avoid hyperinflation and/or accelerating inflation. Both hyperinflation and accelerating inflation hurt the poor because nominal wages tend to lag prices, so that the real wage of unskilled labor tends to fall. The cases of Brazil, Indonesia, and Peru show that the poor gained from the successful elimination of hyperinflation. Monetary or fiscal policy that is so expansionary that it leads to high rates of inflation will typically hurt the poor. There is no clear evidence of any relationship between poverty and inflation when inflation is relatively low (less than 20 percent per year) and not accelerating. Inflation can then be quite fully anticipated. Therefore, forcing the economy through a lengthy recession to bring inflation down, from, say, 10 to 20 percent to 5 percent or less, is likely to hurt the poor even though such stabilization may be justified on other grounds. Concrete policies to avoid high or accelerating inflation include:

> **Spotlight on: Sri Lanka**
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> The possible causal chain from devaluation to inflation to an increase in poverty is a legitimate source of concern for policymakers. In **Sri Lanka,** the tripling of the rate of inflation after the market reforms of 1977 contributed to an increase in poverty as wages lagged price changes and was caused by exchange-rate devaluation together with other reforms.

- Avoiding unsustainable budget deficits. This may require limiting transfers to the nonpoor and strengthening tax collection.
- Limiting the growth in the money supply. This may require measures to sterilize some of the foreign-exchange reserves that are accumulating.
- Reducing the impact of inflation on the poor using social safety net interventions such as self-targeting subsidies on foods consumed mostly by the poor.

10. Keep real interest rates positive (but not excessively high) for both borrowers and lenders/savers. Very low interest rates to borrowers tend to be anti-poor because the poor and small, labor-intensive firms are usually crowded out of the queue for such loans (see the finance section of Chapter Four). At the other extreme, very high real interest rates, above 15 percent or 20 percent, should be avoided as a tool of tight macroeconomic policy to the extent possible. The cost to the poor of recession is high and the impact of high interest rates on employment creation is negative, especially for small firms. This requires limiting the fiscal deficit and massive monetary expansion; otherwise, the use of high interest rates may be unavoidable.

11. Strengthen tax-collection capacity. Strengthened tax collection is especially important where there is an urgent need to increase government expenditures on infrastructure and on education, health care, and other human-capital building, poverty-reducing government activities. Raising the effectiveness of the tax system is often feasible and better than raising tax rates because a low tax intake often signals both inefficiency and corruption in the tax agency, with resulting horizontal inequities (see the Peru country case).

Spotlight on: Peru

In keeping with a tradition of weak administrative capacity in the public sector, the level of taxation in **Peru** has historically been too low to provide sufficient financing for needed social investment. In the early 1990s, a new tax agency significantly raised the efficiency of tax collection and hence the share of GDP available for public spending.

12. Maintain a tax structure that is favorable to pro-poor growth. Tax rates on the income and consumption of the poor should be kept relatively low, both for direct welfare reasons and because of high collection costs per unit of revenue. Taxes on labor discourage employment creation. Excise taxes on goods consumed by the nonpoor, and especially the wealthy, do the least damage to growth and the welfare of the poor. Indeed, these taxes can have beneficial effects on savings and, therefore, growth.

Macroeconomic and Trade Policy Resources

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Labor and Employment Policy

The main objective of all pro-poor policy affecting the levels and conditions of employment is to raise the value of the human capital of the poor. There are two ways to do this. On the demand side, policy should make growth intensive in the use of unskilled labor. In most economies, key sectors are agriculture, labor-intensive industries and services, and, to a lesser extent, construction. A growth strategy led by these sectors is very likely to be pro-poor. On the supply side, investments in education, training, and complementary inputs such as infrastructure should also raise the real wages of the poor. Although higher real wages is one central goal of economic policy, interventions in the labor market designed to raise wages above market levels tend to be counterproductive. The more successful approach has been to gear policy toward increasing labor demand to pull up the equilibrium or market wage, while also investing in worker skills to raise labor productivity. Similarly, attempts to ensure job stability through heavy restrictions on worker dismissal by firms tend to be inferior to other approaches, and often outright counterproductive. The welfare of workers can often be better advanced by policies geared toward lowering the cost of living for workers than by interventions that raise their monetary income.

The broad criterion for labor market policy is that it should complement the information and preferences of market agents (firms and employees) while intervening mainly to correct for the effects of:

- Lack of information; for example, workers not being aware of the dangers of certain types of work;
- Extreme inequality of market power between the two participants in the employer–employee relationship; and/or
- The need for overall stability in the labor market; for example, to keep worker incomes up and thereby avoid recessions because of lack of demand.

Labor and employment policies should also ensure minimum standards, even if they increase labor costs, because some protection for workers may be worth the price in slightly lower rates of employment and income for workers. That would include limits on child labor, protective measures to reduce death and injury on the job and, above all, the creation of an environment where workers are able to organize. One needs to be realistic about the effectiveness of such legislation in countries where jobs in the organized sector are scarce (factories, stores, and construction sites with large numbers of workers) and the alternatives are work on family land, peddling or other informal street occupations, or work in household or small firms, where no protection exists.

In some cases, large firms tend to be capital-intensive; for example, because of capital market imperfections or simply because the country is no longer capital-poor. These firms have price-inelastic demand curves for labor and thus are not candidates to create large numbers of jobs. In such situations, labor legislation and the quality of its design and the pattern of its implementation may have their main benefits and costs within the small and medium-sized enterprise sector. It is therefore essential to reflect an understanding of the situation of that sector in any labor legislation. Will the costs of penalties for firing be very high? In labor-abundant countries, firms of all sizes are more likely to be labor-intensive, so the impact of legislation there is relevant across the board. The implementation of most labor legislation tends to be partial. The implications of the pattern of implementation need to be taken into account in the design of the system.

Labor and Employment Policy Recommendations

13. Avoid steps that artificially raise the cost of labor to employers. Wages significantly above the supply price or the opportunity cost of labor—what workers can earn elsewhere—run a high likelihood of discouraging employment and thereby harming low-income workers and the poor. A gap between wages and the supply price in a few countries and some sectors results from union power. In developing countries, it results much more frequently from minimum-wage legislation. In some countries, especially in Latin America, it results from labor taxes not fully earmarked for worker benefits. Rather than raising the welfare of workers, large nonwage benefits that contribute to the employer's labor cost run the risk of raising the cost of labor, with decreased employment the result. These should be discouraged unless they are demonstrably better for the worker than the cash equivalent. Depending on incidence, labor taxes may also fall substantially on workers themselves.

14. Avoid direct broad-based labor subsidies. Indirect subsidies on the cost of living can work, however. Countries with a high incidence of poverty, and where direct labor subsidies could benefit many people, are unable to afford such subsidies or to administer them. Countries with a low incidence of poverty tend to find superior options. Subsidies that are limited to the formal sector of the economy are almost certain to be regressive, benefiting the near-poor who are employed at the cost of the poor, who cannot find jobs in the better-paying organized sector as a result. Indirect subsidies do not have that disadvantage.

15. Use legislated minimum wages conservatively. If used, minimum wages should provide a floor below which most actual wages would reflect monopoly/monopsony power by the employer, lack of market knowledge on the part of the worker, or some other market imperfection. Such wages can also prevent an undue fall in real wages during bursts of inflation. In countries where equilibrium wages vary substantially by region, minimum wages should reflect such variation to some degree.

Spotlight on: Brazil

The minimum wage can be a useful policy instrument in poverty reduction *only* if the increase in the real minimum wage is sustainable; otherwise, it will simply lead to greater inflation through a wage–price push. The minimum wage must also be set at a level that does not push a significant number of workers out of the formal sector. Both of these conditions appear to have been met in **Brazil** in 1994–1995. They are rarely met elsewhere.

16. Consider self-targeted employment programs to provide income security for members of poor families. Program wages should be kept low enough (usually below the minimum wage) to form an effective self-targeting system. The programs should generate benefits of value to the community, such as infrastructure. These programs can be thought of as involving a wage subsidy, whose efficiency can be justified if market wages are actually above the true cost of labor, or the social opportunity cost of labor, as a result of disguised unemployment. They are also justified under such special circumstances as famines or high seasonal unemployment between cropping activities. Chapter Five discusses employment programs in greater detail.

17. Avoid excessive limitations on worker dismissal. Although job stability is an important and appropriate goal of public policy, dismissal rules that are too rigid tend to discourage hiring in the first place and can thus be counterproductive. Better success is likely to come from efforts to ensure a well-functioning labor market where the demand for labor is high.

18. Avoid policies that create incentives for firms to fire workers. Some elements of labor legislation are structured in such a way as to unduly raise the cost of keeping workers on and hence encourage worker dismissal even though there is no other reason for the firm to prefer this course of action. Such regulations diminish employment stability and are likely to curtail on-the-job training.

19. Raise the real wage of workers by holding down their cost of living. This needs to be undertaken to an extent consistent with efficiency objectives. Rising productivity in food staples and falling real food prices have been two of the most important contributors to raising real wages in many countries. Efficient investment in housing for poor families (including sites and services projects) can be important, although care must be taken that the spending not be directed toward middle-income groups. Subsidizing low-cost urban transportation, which is often desirable on efficiency and environmental protection grounds, can have the added advantages of keeping the cost of living down and increasing job access for the poor. If there is disguised unemployment in the sense that market wages are above the social opportunity cost of labor, such subsidies can also be justified on economic efficiency grounds, helping to overcome market imperfections.

20. Avoid subsidies to the use of capital. The exception to this recommendation is under very special circumstances, when investment in such capital is likely to significantly raise the demand for labor. One argument against overvalued exchange rates is that they constitute a subsidy to capital, which raises the cost of labor relative to that of capital. Subsidies to capital, however, encourage the use of capital-intensive technology and of capital-intensive activities, which is clearly not pro-poor.

21. Provide appropriate policy support to sectors and activities that generate high demand for female employment. Garment exports have played this role in many countries, as has emigration of women workers, to a lesser degree.

22. Develop carefully designed legislation on working conditions when such legislation can be appropriately administered. Protecting workers from unsafe or otherwise harmful working conditions is desirable. However, a balance must be drawn so it is not pursued to the point of unduly reducing workers' job opportunities and contradicting informed preferences. Workers also need to be protected against nonwage exploitation by employers (such as sexual harassment). Improving worker knowledge of health-related and other implications of working conditions is desirable. Policies to help firms improve those conditions at low cost are also beneficial because good health and safety measures can benefit the firms as well as the workers.

23. Apply similar principles with respect to the protection of women and children from certain types of jobs. In many countries, legislation bars women from certain jobs on grounds of lack of physical strength, inappropriateness, and other reasons. Sometimes, such barriers prevent women from having access to remunerative jobs they could do. Such legislation deserves updating to reflect changing views of what is appropriate, to recognize the trade-off between prohibiting certain activities and the poverty that may result, and to focus more on making jobs safer, rather than using blanket prohibitions. For children, labor legislation should be protective but realistically designed, reflecting recent studies on what sorts of work keeps children away from school and what sorts have permanent negative effects on health. Legislative and administrative efforts in this area should focus on truly dangerous activities, rather than on a wide range of activities that may not be very damaging. In any case, these activities might not realistically be brought under control and may force the children of very poor families into such sectors as family agriculture or household help, where their incomes and their protection may be compromised.

24. To the degree possible, base policies to discourage child labor on positive incentives. Negative legal mandates are less effective than incentives. Such mandates are difficult to administer and may be damaging to the interests of the poor. On the other hand, providing monetary incentives to encourage school attendance can provide a win–win alternative by encouraging school attendance without associated income loss to the family.[8] Such conditional cash transfer programs are discussed in greater detail in Chapter Five.

25. Consider subsidies, tax rebates, or other forms of support for on-the-job training. Some degree of such support is warranted by the general arguments for subsidization of certain types of education. An additional degree is justified on the grounds that employers' need for considerable flexibility to increase and reduce workforces to remain competitive can curtail such on-the-job training below its optimal level.

26. Do not actively discourage labor mobility between jobs, regions, and so on. In general, the movement (migration) of labor in response to market forces such as wage differentials contributes to overall economic efficiency and should not be discouraged unless the movement itself is the result of a market imperfection. In some situations, it may even be desirable to provide some support to facilitate labor mobility.

Spotlight on: Sri Lanka

Since 1977, **Sri Lanka's** reforms have permitted and even encouraged migration. As a result, nearly half of the net increase in the labor force between 1978 and 2002 went abroad rather than exerting downward pressure on domestic wages. Two-thirds of the migrants were women, the great majority of them maids, so the benefits accrued particularly to poor unskilled women.

[8] An interesting example of such an incentive system is the PETI program in Brazil, which provides a cash incentive for families to keep their children in school and out of bad work environments (see the Brazil country study and Chapter Five).

27. Facilitate worker migration to other countries when doing so can produce a significant set of benefits from remittances and increased local wages through reduction of labor supply.

28. Exercise restraint in the implementation of reforms designed to remove perceived imperfections. Although in many countries labor market institutions—legislation, practices, unions, and so on—appear seriously distorting, care should be taken before launching major related reform efforts, because there is at this time little serious empirical evidence that such reforms, where carried out, have brought significant benefits (see the Peru country case study). It may be the case that beneficial effects take a long time to show up, that the costs of distortions have been overestimated in the first place, or, most worrying, that once an economy has operated for a long time under such institutions it will in practical terms never behave as it would have had that system not been put in place at all (for example, while the country still experiences a labor surplus).

29. Develop public and private investment projects in infrastructure, such as farm-to-market roads, communications systems, and irrigation. Such projects make the poor more productive and raise their income in the long run, while also raising the income of unskilled construction workers in the short run, during the construction phase.

Labor and Employment Policy Resources

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Countries in Transition, Berlin: Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).

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Useful Web Sites

www.ilo.org/public/english/employment/recon/poverty

The **Employment and Poverty** section of the International Labour Organization Web site is the home of the Department of Recovery and Reconstruction research program on linkages between economic growth, employment, and poverty. The research program stems from the perspective that productive and remunerative employment plays a central role in making economic growth pro-poor. The site contains an extensive series of working papers available online.

CHAPTER FOUR
SECTOR POLICIES AND PROGRAMS

This chapter examines four key sectors and their relationship to pro-poor growth: education, health, agriculture, and finance. The chapter also presents pro-poor policy recommendations in each of these sectors, as well as resources for further reading.

EDUCATION

Education is widely thought to be central for promoting efficient growth and for increasing the assets of the poor to bring them out of poverty, although with some lags in these effects. The prevention and cure of diseases and disability also have important roles to play in pro-poor growth, partly because, as with education, some of the highest payoff investments involve poor people. There is evidence of strong productivity effects of better health and nutrition. Investments in both areas have the added advantage of contributing directly to the quality of life independent of their impact on incomes. Many types of investments in these areas seem to have yielded high returns, suggesting that many good investment opportunities remain. However, the benefits also appear to vary greatly from one investment to another. It is thus essential to evaluate each investment carefully.

Education should be interpreted as learning that may increase productivity and improve welfare. The term thus includes not only schooling but also learning at home, in the community, and on the job prior to, during, and subsequent to formal schooling and training programs.

Education Policy Recommendations

1. Recognize that education entails more than formal schooling. More attention must be paid to evaluating education outside of formal schooling (for example pre-school programs and adult training and education programs) as well as to improving the evaluation of formal schooling.

2. Be conscious of policy trade-offs. Some policies are "win–win" in the sense that they improve efficiency (contribute to growth) and also benefit the poor disproportionately. The private costs of most human-capital investments must be financed by individuals or their families. This obviously limits particularly the human-capital investments of the poor. Improved access by them to capital markets to fund such investments (whether in human or other capital) would improve efficiency and would particularly benefit the poor and increase their human-capital investments. On the other hand, greater subsidies for higher education in technical fields might contribute to growth and increase efficiency because of the external benefits of better technology, but these subsidies will almost wholly directly benefit students from higher-income families. The latter policies involve a trade-off between efficiency/growth and better distribution.

3. Distinguish between private and social rates of return on different types of education. The fact that some public policies, such as investments that increase schooling, generate productivity gains does not mean they are desirable in terms of efficiency. What is central for that assessment is the difference between the social and the private rates of return. The former refers to net gains to the whole society, including people other than the recipients of the education; the latter refers only to those recipients. Net gains to society may be small or negative even if the private rates of return are high (as, for example, for most forms of tertiary schooling). Public investment is warranted only when the net social benefits exceed the net private benefits. One factor contributing to a high social valuation of education is that it is seen as a merit good, something of which everyone should have a reasonable amount.

4. Recognize that the rates of return on investing in the education of the poor appear substantial in many cases. Education-related rates of return are comparable to or exceed those on many other investments, with those for investing in females often at least as high as those for investing in males. The relatively few careful studies of the returns on educational investments, although limited primarily to formal schooling and to only a few contexts, suggest that carefully selected investments can achieve high rates of return and be pro-poor. Where high returns accrue to the education of females relative to that of males, this is at least in part because female education has a greater impact on important outcomes related to health and nutrition and perhaps the education of the next generation. Careful evaluation of such educational policies must be undertaken in each context where they are being considered. Where implemented, the evaluations should be updated with new information that becomes available from careful monitoring.

5. Recognize that rates of return on education depend, importantly, on market, policy, and cultural contexts. Rates of return on education are likely to be higher where there is an ongoing stream of market and technological changes; in other words, where the economy is growing. Rates of return on female education are likely to be higher in societies in which females have flexible choices regarding their time use and occupations.

6. Focus on the parts of the life cycle in which the returns are likely to be highest and include health and nutrition support among the policy tools. The rates of return appear to be relatively high for early education and for complementary human-capital investments in health and nutrition from conception onward. In many developing countries, therefore, win–win pro-poor policy improvements are likely to be made possible by shifting resources away from high per-student subsidies for tertiary/university schooling (where most of the students are from middle- and upper-income families) toward basic education (including pre-school programs) and infant and early-childhood health and nutrition.

7. Improve access to basic education. In most developing countries, primary schools are now accessible for most children. Those significant pockets where this is still not the case are likely to be costly in terms of the objective of pro-poor growth. Increasingly, the school-access question comes into play at the secondary level. Policies are likely to be much more effective in terms of pro-poor growth if they do not discriminate between public, private, and other schools, thus encouraging a variety of new providers to increase competition.

8. Improve educational quality, which has a high payoff in many countries. School quality includes multiple dimensions: class size, teacher-to-student ratios, teacher education, curriculum development, supplies of textbooks and other materials, and decentralization. Although the returns on improving some dimensions of school quality appear considerable in many developing countries, there are no magic formulas, as such returns are sensitive to local conditions. Policies therefore need to be evaluated with careful attention to local conditions, directed toward all potential providers of educational services, monitored and updated as necessary.

9. Before using mandates to attempt to increase education, obtain more information about their effects. Mandates (for example, that everyone should be in school until a given age) are often less effective than commonly believed. Moreover, these mandates often compromise the welfare of poor members of society. Such mandates may sometimes be appropriate, but their effectiveness should be considered carefully in comparison with alternatives, such as increasing positive incentives to attain the same objectives.

10. Provide effective incentives for increased education, such as scholarships for students from poor families. This particular form of incentive seems to have been effective in increasing schooling in several recent experiences, but such programs need to be evaluated and monitored carefully over time rather than blindly transplanted. In some contexts, they may have significant negative congestion effects, inducing increased enrollments in already overcrowded schools. In other contexts, they may not be the most efficient way to foster income growth among the poor.

11. Improve information about what educational providers are providing. Imperfect information about what educational providers are doing is the basis for some central tendencies in the educational sector, such as favoring public over other providers and mandating changes that are thought to be in the interests of the poor, although the poor may not understand this. In such situations, there are likely to be alternatives that are higher in the efficiency and pro-poor policy hierarchies—for example, the provision of better information to parents and students and the development of mechanisms to help them use such information effectively.

12. Improve information and evaluation of the rates of return on alternative strategies for increasing education. Good systematic evaluations of educational policies are rare and probably are biased toward successful programs. These evaluations, moreover, do not necessarily provide sufficient information to permit the successful transplanting of such apparently successful programs to other contexts. The costs of good evaluations are small compared with those of the policies being evaluated, suggesting that the systematic evaluation of educational policies should be the norm rather than the exception.

Education Policy Resources

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HEALTH AND THE HIV/AIDS CHALLENGE

Health

The poor are severely disadvantaged in their health status. In many developing countries, health-sector priorities need to be reoriented so they better reflect the contribution that improved health can make to pro-poor economic growth. The health-sector priorities that contribute most to pro-poor economic growth appear to be those that increase the supply and productivity of labor; complement human-capital investments; and reduce the dependency burden.

In some cases, the health disorders that limit progress in these areas are already effectively targeted by interventions supported by public health systems. In other cases they are not. Most public health systems place a strong emphasis on programs targeted to children under five and less on health disorders that cause disabilities.

Health Policy Recommendations

13. Consider allocating relatively more resources to health disorders that cause disabilities or malaise (thus cutting into work time) and less to health disorders that result in mortality. Health problems that have probably received too little attention in the past include such important causes of disability and/or loss of work time among working-age adults and school-age children as mental disorders (particularly unipolar depression) and types of injuries that could be lessened by stricter licensing requirements for drivers and safety checks of vehicles; by the required use of helmets among motorcycle and bicycle riders; and by stricter measures designed to reduce the consumption of alcohol and drugs by persons operating motor vehicles. Investments could include those designed to prevent and/or treat blindness and other visual impairments such as cataracts, adult hearing loss, and osteoarthritis. Priorities should be made on an individual country basis. There are important differences between countries regarding the social and economic impact of adult mortality and disability and regarding the relative costs of different interventions.

14. Accord higher priority to other health-related investments that prevent poverty directly. Investments that reduce a poor household's vulnerability to the risk of catastrophic health-care costs will also reduce poverty. In some countries, the easiest way to achieve this in the short run is by increasing public funding allocated to public hospitals. Although this recommendation contrasts with the conventional public health prescription that the bulk of public funding be allocated to primary (and particularly preventive) health care, it is suggested by a careful consideration of the role hospital subsidies play in preventing poverty. Other practical ways to reduce vulnerability to the risk of catastrophic health-care costs, and to improve access to needed care, include expanding opportunities for rural saving and access to affordable rural credit, using publicly financed equity funds to pay the hospital costs of the poor, and adopting community health insurance and other community health financing schemes.

15. Complement the health-related investments of poor and near-poor households with other efficient investments. These investments should be in areas such as food security, rural infrastructure (particularly roads, water, and sanitation), improved housing, and improved environmental conditions. Absence of these complementary investments increases the cost of health-care investments to the poor. Poor water supply, for example, has a large impact on infant mortality and on days lost from work because of illness. Investments in formal education, rural roads, water, and sanitation already figure prominently in developing-country poverty reduction strategies. More attention should probably be given to adult basic education and literacy, whose effects are immediate and which are self-targeted to the poor and to promotion of efficient alternatives to the indoor use of biomass- and coal-burning stoves.

16. Make efficient investments that remove or reduce barriers to health-related investments for poor and near-poor households. Initiatives should be implemented on a national level only after careful evaluation has established their effectiveness. Examples include:

- Better health education for adults and children;
- More effective regulation of private health care through control of unlicensed drug vendors;
- Regulation of the sale of potentially harmful prescription drugs without a prescription;
- Adoption of transparent fee and exemption policies in public health-care facilities;
- Targeted demand-side subsidies (vouchers, subsidized health insurance) to improve access by the poor to key health-related services;
- Targeted subsidies for health care–related transportation costs, including reimbursement of costs from home village to primary-care facilities and subsidized ambulance (or public transportation) costs from primary-care facilities to referral providers;
- Use of pro-poor formulas for the geographic allocation of public health resources; and
- Contracting out the operation or the management of public health facilities to NGOs or commercial providers.

The HIV/AIDS Challenge

In recent years, HIV/AIDS has emerged as a major factor likely to affect African countries' patterns of economic growth and poverty reduction. As HIV/AIDS now spreads in Latin America and the Caribbean, Asia, and Eastern Europe, these concerns will become increasingly pertinent in those regions, as well. Although most diseases undermine economic development and hurt the poor disproportionately, HIV/AIDS is uniquely damaging in terms of poverty and economic growth because of a combination of factors, including its concentration among adults between 15 and 49 years of age, the cohort that is most productive economically; its long dormant period, which allows it to become deeply rooted in communities before it becomes a visible threat; and the resulting very high economic and social costs. Its catastrophic effects on families include the creation of huge numbers of orphans whose childhood is one of poverty, and the resulting intergenerational transmission of that poverty. The HIV/AIDS phenomenon places a great premium on better savings channels to prepare families for the impact of the disease and better insurance systems to help them deal with that impact.

Reversing the HIV/AIDS epidemic must be a top-priority goal in many developing countries. For those with low-prevalence levels, this task is easier and can be accomplished largely within the realm of health-related programs. In highly affected countries, however, the task is to protect hard-won development gains from the economic, social, and human ravages of HIV/AIDS, and the response requires participation far beyond the health-care field. Although the challenge of designing a response to a health-related crisis of such magnitude and complexity as HIV/AIDS is daunting, there are some opportunities to (1) slow the epidemic, and (2) protect the poor's access to economic activities even in an HIV/AIDS-affected environment. Recommendations are presented separately at the policy level and the project level.

HIV/AIDS Policy-Level Recommendations

17. Slow the spread of the disease before it becomes entrenched in the general population. In low-prevalence settings, this is the best way to reduce the impact of HIV/AIDS on pro-poor economic growth. The common and crucial element in the few countries that appear to have actually slowed or turned the epidemic at an early stage (such as Senegal and Thailand) has been a committed national political leadership. Encouragement and support to indigenous, national leadership on HIV/AIDS even where AIDS is least visible may be one of the most important ways to reduce the long-term economic impacts of the epidemic.

18. Help national policymakers prioritize AIDS responses around sectors that will secure long-term development gains, such as education, health, and agriculture. In high-prevalence countries, HIV/AIDS issues need to be incorporated in development and poverty reduction planning. In the African context, these key sectors must continue to function throughout the AIDS crisis for the country to maintain the preconditions for long-term pro-poor economic growth.

19. Recognize and plan for the various perverse interactions between HIV/AIDS and negative economic shocks, especially drought and famine. The poverty-increasing effects of these latter episodes are accentuated by the presence of HIV/AIDS unless effectively counteracted by more effective prevention of and response to droughts and famines.

HIV/AIDS Project-Level Recommendations

20. Modify projects to allow labor- and capital-poor AIDS-affected families to continue to participate in development activities. This recommendation applies to moderate- and high-prevalence countries. In agriculture, such innovations may take the form of labor- and capital-saving technologies or those that allow women-, senior-, or child-headed households to accomplish agricultural tasks previously undertaken by men. In the education sector, programs in girls' education may include a distance-learning (radio) component, recognizing that girls are most often removed from school in AIDS-affected households.

21. Develop mechanisms of channeling resources to families that will otherwise resort to irreversible coping behaviors. In moderate- and high-prevalence countries, such mechanisms include providing incentives to keep children in school and avoid the sale of land, or allowing child-headed households to receive direct grant support. These resources are likely to be most essential for women, children, and the elderly, groups that bear the heaviest burden in coping with the costs and impact of AIDS.

22. Monitor the impact and systemic costs of HIV/AIDS in each priority sector, and monitor and evaluate the effects of ongoing interventions. Given the recent nature of the HIV/AIDS challenge and the even more recent experience with policy interventions, such information is critical for effective planning and response, especially in moderate- and high-prevalence countries.

23. Ensure that development activities are not putting participants at risk of HIV infection. For example, development policies and programs that encourage population mobility could put individuals at greater risk of infection (such as programs that shift women from subsistence to commercial agriculture). The costs of increased HIV/AIDS infection must then be weighed against the benefits of the activities.

24. Use development platforms as an opportunity to transmit information on how to avoid HIV infection, how to support those coping with HIV/AIDS, and how to live positively with HIV/AIDS. This sort of "call to arms" reduces the stigma around AIDS and provides information within forums where people already work together and can support each other; for example, within a school system, a health-care clinic, a farmers' association, or a local government institution. Tools now available to provide workplace programs in prevention education can be adapted to better match these alternative platforms.

Health and HIV/AIDS Resources

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AGRICULTURE

In many settings, agriculture has the potential to be the engine of pro-poor growth. There is powerful evidence that the performance of the agricultural sector specifically, and the rural economy more broadly, is a key factor influencing the rate of overall economic growth and its impact on the poor in those countries where poverty is most severe. This influence is felt most where agriculture is based primarily on smallholders and technology is available to increase productivity in a scale-neutral fashion. In such settings, agriculture tends to be much more labor-intensive than other sectors, both on average and at the margin, and thus income growth in agriculture tends to be pro-poor. Along with direct employment creation in agriculture goes the upstream indirect employment effects in shipping, processing, storing, and marketing. Obviously, many countries fall outside this description, especially in Latin America, and in such settings other approaches to pro-poor growth will need to be found, but in much of Asia and the smallholder areas of Africa and Central America, agricultural growth offers the best hope for reducing poverty through economic growth.

Many of the determinants of performance of the agricultural sector are beyond the control, even the influence, of policymakers, especially in the short run. Rains, drought, pests, and diseases are the daily concern of farmers everywhere, no matter what leaders do in Delhi, Jakarta, Lima, or Nairobi. Perhaps of more concern, judging from the historical record, is that much of what these leaders do with respect to agricultural productivity and rural incomes is counterproductive. Accordingly, this policy list contains as many “don’ts” as “dos,” and because of the vast heterogeneity of agricultural systems around the world, nearly all of the recommendations are (or should be) hedged in one way or another.

Following Hayami and Ruttan (1985), the dos list is composed of five “i” words:

- Incentives,
- Inputs,
- Infrastructure,
- Institutions, and
- Irrigation.

The list of don’ts is more heterogeneous: Don’t subsidize interest rates in rural credit programs; don’t use food aid except to relieve humanitarian disasters (unless you increase demand simultaneously); don’t control markets through government parastatals; don’t tax agriculture more heavily than the rest of the economy; and don’t bias the provision of public goods and services in favor of urban areas. Ending urban bias, where it exists, even without specific steps to enhance agricultural productivity, would do loads of good for the poor.

Both lists focus on “getting agriculture moving,” to use Art Mosher’s evocative title for an influential book published in 1966, and only incidentally emphasize specific pro-poor dimensions of policy guidelines. There are specific actions that can be taken in some settings to enhance agriculture's pro-poor nature—land-titling programs that allow smallholders to use their cultivated land as collateral at rural banks; active concern for technology choices available in irrigation, agro-processing, and transportation; and possibly even land redistribution and tenure reforms where the politics would not turn bloody.

But the major impact of agricultural growth on the poor will be where it stimulates the macro economy, with positive impact on the poor, and enhances that impact because of its labor intensity. Thus, the limited attention to specific pro-poor dimensions of agricultural policy is not a problem in those countries where these linkages are effective and the potential exists for gains in agricultural productivity. For many of the poorest countries, these conditions hold, and meeting the Millennium Development Goals for poverty reduction will require implementing most of the components on this agricultural policy list—doing the dos and not the don'ts.

The hedged nature of these lists is a problem and a challenge to the user. Local adaptation will be critical where recommendations are sharply conditioned by local ecological settings, by the historical path of policy initiatives and outcomes that determine the starting point for new approaches, and by the conditions of governance and bureaucratic capacity to design and implement such approaches. Every country will need the analytical and bureaucratic capacity to translate these general policy recommendations into specific policy approaches, socially profitable investment programs, and effective rural development projects. The details will vary widely, but the basic objectives will remain: rapid growth in agricultural productivity to stimulate the overall economy and reduce poverty. Note that this productivity growth need not imply rapid expansion of output if agricultural resources are able to leave the sector and earn higher rates of return in industry or services. With rapid migration of rural labor to urban jobs, rising productivity of labor in agriculture is perfectly consistent with modest increases in output.

Spotlight on: Egypt

Reform of **Egypt's** rice sector resulted in increased production, significant employment generation, higher prices for farmers, lower prices for consumers, and increased exports. Before the reform program began, all stages in the rice sector, from farmers to consumers, were controlled by the government. Because more than half of rural households are involved in rice production, the sector's liberalization has significantly reduced poverty in rural Egypt.

Getting Agriculture Moving: What to Do

Most agricultural systems in developing countries produce a wide array of both tradable and nontradable commodities (often the same commodities in different locations). As J. W. Mellor has emphasized recently, much of the agricultural development process involves converting nontradables into tradables, often through investments in rural infrastructure and processing facilities. Accordingly, this transformation process will depend heavily on appropriate macroeconomic and trade policies that favor the production of tradables, whether for domestic or foreign consumers. The list of these broader policies is presented below separately from the agricultural policy recommendations.

The five “i” words provide a convenient umbrella to organize the specific positive elements of the agricultural policy list. Each has several elements, and most are linked to one another in critical ways. The discussion below also notes areas where there is substantial controversy over the recommendation (or its exclusion).

Incentives

Agricultural growth that contributes to overall economic growth is possible only if it is profitable. Hence, incentives facing farmers will be the primary determinant of what they grow and how intensively they use available inputs and technology. On a sectoral basis, these incentives are determined primarily by macroeconomic forces—the rate of aggregate economic growth and the real exchange rate—and by trade policies that affect rural–urban terms of trade. Specific commodity policies can also be used to affect incentives—import duties and export taxes, floor and ceiling prices, and differential domestic taxes and licensing arrangements. There are clear examples where such specific commodity pricing policies have been used to stimulate more rapid adoption of new technologies—rice in Indonesia in the 1970s, for example—but far more examples where the policies simply transfer economic rents to producers, to the great detriment of the poor. When the intervention discriminates against farmers and lowers food prices, the poor can benefit in the short run, but the sustainability of such a tax on agriculture and/or the drain on the budget is highly problematic.

Inputs

Inputs are the vehicle for translating new agricultural technology into higher productivity. New genetic potential incorporated in seeds, improved formulations of fertilizers and other agricultural chemicals, and more effective mechanical equipment keep pushing out the technical frontier of best agricultural practices. To adopt these innovations (assuming the incentives are in place), farmers need the management know-how and financial resources to make the investments. In both arenas, poor farmers are usually at a disadvantage, and some targeted extension activities often are helpful in reaching them. But input subsidies are almost always the least pro-poor instrument available for stimulating more intensive input use, especially when they are used to subsidize rural interest rates or mechanization programs. The record on fertilizer subsidies is more mixed—in some circumstances, such subsidies have served as effective “second-best” substitutes for failures in technical knowledge, credit availability, and risk markets, thus speeding adoption of new technology more broadly. To be effective, fertilizer subsidies must affect the market price, not just limited quantities available on ration, but they then become very expensive to the government budget. Clear plans for phasing out such subsidies should be made if and when they are introduced.

Infrastructure

The gradual conversion of rural nontradables to tradables available to the rest of the domestic economy and to international trade—the "analytical" definition of agricultural development—requires extensive investment in rural infrastructure. Market roads are the key, of course, but communications systems and rural electrification are also important in lowering the transactions costs—including the risks—of trading commodities. In addition, governments have an important role to play in building market facilities that traders can use for doing business and seaports and airports for agricultural exports, and even in developing cold storage facilities that help domestic farmers gain access to supermarket supply chain managers whose volume of business is expanding in most parts of the world at revolutionary speed.

Institutions

A wide array of institutions supports and influences the agricultural sector and rural economy, from the broad institutions of economic governance to the local credit office or water users' association. It is difficult, for example, for farmers to engage in contract farming arrangements with food processors or supermarket procurement officers where contracts cannot be enforced at reasonable cost. The East Asian experience, in particular, has emphasized the evolution of a rich array of rural organizations and institutions in support of farmers. These range from formal cooperatives, often established with the active support of government agencies, to farmer associations set up by processors or marketing agents to lower the transactions costs of dealing with individual small farmers. Financial intermediation in rural areas usually requires some degree of farmer cooperation—the collateral of social capital—or government assistance in the start-up phase to cover overhead and training costs for local bank officials. From a development perspective, it is best to have these local banks formally linked to a national banking system, rather than as stand-alone units doing microfinance. Of course, the poor may not be well-served by the national system in the early stages and microfinance programs may be their only way to access financial services (see the "Finance" section below).

The institutions of local governance can also impact agriculture directly, especially where the local tax base depends on land taxes or commodity trade taxes. The widespread tendency to decentralize government powers and taxing authorities can create serious burdens from heavy agricultural taxes, as experience in China has demonstrated. Allowing farmers an active voice in local government, especially in local taxation and expenditure policies, will be an important safeguard in this process.

Irrigation

Nobody is an "irrigation specialist" anymore. Workers in the field want to be called "water engineers." The lack of status for irrigation specialists stems from the difficulties with large-scale irrigation projects experienced over the past several decades. These include massive cost overruns, production of crops with poor economic returns, occasional environmental disasters, and a need for frequent rehabilitation because of poor management of operations and maintenance. Still, the historical contribution of massive investment in irrigation, especially in Asia, to increasing food production and lowering food costs for the poor must not be ignored because it stimulated one of the most pro-poor growth episodes in human experience. What is left to do in irrigation? Clearly, better attention to operations and maintenance is essential to raising the return on existing irrigation investments, and local water user associations are probably critical to achieving this. New technology is also emerging that is economical even for small farms—for example, small electric or diesel tube wells for basic commodity production and low-tech drip irrigation systems for high-value vegetables and tree crops maximize the efficiency of water use and place water management directly in the hands of farmers. Public policy issues remain with these systems, of course, especially in terms of monitoring the drawdown of water tables and the need for adequate drainage, but irrigation investments remain an important element of increasing agricultural productivity, lowering the risks associated with farming, and stimulating diversification into higher-value commodities.

Agriculture Policy Recommendations

In general, agriculture has been undervalued relative to its social profitability, and public investment in the sector has been well below what is justified by its contribution to economic growth and reductions in poverty. In addition to this general urban bias, there are many specific policies and actions governments take that are directly harmful to farmers and the rural economy, even if there are good intentions in the capital city. A list of five general examples follows, but it does not begin to exhaust the need to start much policy advice with the word **"don't…"**

25. Don't subsidize interest rates in rural credit programs. A well-functioning rural credit system is essential to a successful structural transformation, to the rapid adoption of new technologies, and to efficient marketing operations. When asked about their most pressing needs, nearly all farmers will respond that they need access to cheaper credit. It is tempting to make this available through government-subsidized loans, either directly or through rural banks. This is always a mistake, especially with the interests of the poor in mind. They never have the political clout to get access to this "free money," and its provision inhibits the development of a sustainable rural financial system to which they could gain access. As noted under "Institutions" above, modest support for start-up costs, including training, for rural credit programs might well be appropriate to get things moving.

26. Don't use food aid as a substitute for domestic food production, unless the increased supply is at least matched by increased demand. "Food for peace," "feed the hungry," "solve the problems of poverty and malnutrition with the abundance of American agriculture": the motives are noble, but except in clear humanitarian disasters, the easy availability of food aid tends to undermine local markets, reduce incentives for domestic production, and create an environment of dependency. If food aid is needed in a particular circumstance, it is best to buy it locally to stimulate local production. If food aid is the only aid that is available, it must be used very carefully. For example, if demand for food can be increased by as much as the additional food aid supply through funding for labor-intensive public works (and no other form of aid is available to do the same task), the disincentive effects are minimized or can be avoided.

27. Don't control markets with government parastatals. Neither farmers nor consumers like unstable food prices, and free markets can often be chaotic. It is understandable that even well-meaning governments will want to control these markets and will find parastatal logistics agencies to be useful in the task. Of course, venal and corrupt governments will also find such agencies useful in the generation of rents. The pressures to evolve from well-meaning (and sometimes even effective) market stabilization to corrupt control are powerful, and the impact of corrupt parastatals on market efficiency is devastating. Both farmers and consumers lose in such a world. With world grain markets more stable over the past decade than during the tumultuous 1970s and 1980s, and expected to stay that way, relatively open borders and international trade can provide the food price stability desired by both farmers and consumers. Some modest degree of protection against subsidized imports from rich countries probably makes sense to provide adequate incentives for domestic farmers, but great care must be taken not to harm poor consumers in either the short or long run. It is hard to imagine circumstances where protection of more than 10 percent would be desirable on either growth or poverty grounds.

28. Don't tax agriculture more heavily than nonagriculture. Governments need revenue to carry out the basic affairs of state, invest in public goods, and provide essential safety nets for the poor. In poor countries with primarily rural economies, taxing agriculture has been and will be one of the few ways to generate this revenue. But it is tempting to rely on agricultural taxes, both direct and indirect, even as the industrial and service sectors develop. Such differential taxation tends to hurt the poor the most and directly reduces the incentives farmers need to raise agricultural productivity. The principles of efficient and equitable taxation are well-known; they should be applied to agriculture as well as to the rest of the economy. Of course, this may mean higher taxes on agriculture in those environments where landowners are politically powerful and have been able to shift the burden of taxation to consumers and/or the industrial and service sectors.

29. Don't prolong urban bias. Cities are the center of government, culture, and modern sector jobs and are the best hope for effective education and health care. Urbanization is one of the most pervasive trends during structural transformation and can reflect the success of a rapidly growing economy. Migration from rural to urban areas is often the best hope for the rural poor, and finding suitable infrastructure there in the form of public transportation, water and sanitation facilities, public schools, and other urban amenities will make the transition less painful. None of these factors can excuse the profound bias seen historically in most of the developing world in the rural–urban terms of trade and in the provision of public services to urban areas compared with rural areas. Since the late 1980s, much of the macro and trade bias has gradually been corrected through structural adjustment programs, more open trade regimes, and macro reforms, but a fairer and more efficient distribution of public investments in and policy attention to rural areas will be among the most effective actions the public sector can take to reduce poverty.

Agriculture Resources

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FINANCE

The role of a financial system in growth is to encourage savings, to transfer them at low cost to their best users, and to ensure overall financial stability. The depth and effectiveness of the financial system benefit the rate of growth by increasing savings and investment (capital accumulation), the efficiency of allocation of that capital among users, and the rate of technological innovation. New technologies are often embodied in capital equipment, in which case the two functions go together. More generally, the introduction of new technologies often entails risk and large fixed investments, and a strong financial system helps facilitate this process.

Apart from its impact on growth per se, a pro-poor financial system helps to reduce poverty by its impact on the pattern of growth. This occurs in particular through its capacity to channel funds effectively to micro, small, and medium-sized enterprises (agricultural and nonagricultural) and to encourage saving among low-income people. The importance of getting an appropriate level of funding to micro, small, and medium-sized enterprise, whether through the credit system or through individual-enterprise savings, follows from the fact that their labor intensity gives these firms special potential to generate earnings for low-income families.

In agriculture, the main element of success has been seasonal finance related to the crop cycle, and it tends to be provided by suppliers of inputs and the traders who purchase the outputs. The main role of financial institutions, then, is to supply credit to these intermediaries. In microfinance, the challenge is to provide small loans to clients without collateral at low enough cost to make the system self-sustaining. In the nonagricultural SME sector, the general challenge is to provide capital reasonably early in a firm's life and to reasonably small firms. A more specific challenge is to provide such finance at the time that firms have major growth opportunities.

The main benefit of microfinance is to raise the productivity (and hence the income) of the very small borrower, whereas in the case of SMEs the objective is both such productivity growth and/or firm expansion. Both agriculture and the SME sector have, in differing degrees, been the targets of credit supplied by public-sector financial institutions. The overall record of such institutions has been unsatisfactory in terms of the cost of operation and, especially, the repayment rate, and in reaching poor or small clients.

The growth of microfinance institutions over the past few decades has confirmed that loans can be provided to very small borrowers at much lower cost than previously thought possible. Furthermore, repayment rates can be much higher than commonly expected, and interest rates do not need to be, nor should they be, concessional for these favorable outcomes to emerge. The modus operandi of these institutions differs significantly from that of commercial banks in a variety of ways that generally reduce costs and shift the burden of dealing with the financial institution's risk from use of collateral to other techniques. In Latin America, there has been a recent trend toward professionalization and commercialization of microfinance, with the share of such finance handled by NGOs falling and that by formal profit-oriented financial intermediaries rising. Patterns vary elsewhere. In Asia, state banks have played a bigger role, and there has been a preponderance of self-help groups and NGOs. Overall, the experience of many of the countries that have suffered financial crises over the past couple of decades is that loans to small borrowers can be less risky than loans to large borrowers (see the Indonesia country case study).

The challenge of SME finance is not the creation of a different style of financial institution from the commercial banks but the strengthening of those banks' capacity to better serve small clients, through cost-reducing administrative innovations, personnel training, and the like. It is accepted that most small firms will continue to be established on the basis of self-funding but that commercial loans are important for their growth.

Given the differences between many (for example, NGO-based) microfinance institutions and the commercial banks, an additional challenge is to smooth the transition ("graduation") of successful borrowers from the former to the latter. A further challenge is broadening the range of financial services available to low-income families and small firms.

The recent plethora of banking and financial crises highlights the importance of a stable financial system to avoid major losses to stakeholders and to the economy as a whole. From a pro-poor perspective, such stability is especially important to avoid losses to small savers and prevent the usually rapid shrinking of credit access to small firms during financial crises.

Finance Policy Recommendations

The following policy recommendations fall into three categories. First are regulatory or other proposals designed to steer institutions away from behavior patterns that are damaging or dangerous. Second are proposals designed to lower transactions costs and hence increase both the efficiency/profitability and the potential coverage of the institutions. Third are proposals designed to expand the coverage of financial institutions to increase their pro-poor orientation. Some are relevant to microfinance, some are relevant to SME finance, and some are general.

General

30. Never offer below-market interest rates to borrowers. Subsidized interest rates encourage rent-seeking, on-lending to different uses than those intended, corruption, and sustainability problems. Below-market interest rates tend to prevent the funds from reaching the intended users.

> **Spotlight on: Sri Lanka**
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> **Sri Lanka's** government-owned commercial banks had a history of providing loans at below market rates to favored borrowers. If they operated at a loss, it was difficult to determine whether that was due to their supposed social objectives of providing cheap credit or their inefficiency, including high labor costs for well-organized and politically powerful bank employees. They did not play an increasing and dynamic role in economic growth or poverty reduction.

31. Make real interest rates for small savers significantly positive. A return on savings can lower poverty by acting as an inducement to increase savings and to the creation of small enterprises. Support for informal savings groups and for multibranched savings institutions (such as postal savings systems) are worth consideration in this connection.

32. Never forgive credit. This practice promotes pernicious behavioral patterns that can quickly erode the sustainability of a financial system and with it the potential to provide benefits to the intended clients.

33. Develop bankruptcy procedures or improve them where they are inadequate. Procedures are needed to deal with borrowers whose businesses fall into bankruptcy.

34. Discourage governments from providing credit directly. Where governments do channel funds to borrowers, this should be done indirectly, through existing banking institutions. Direct provision is too prone to corruption and inefficiency.

35. Encourage improvement of overall regulation and supervision of the financial system, which is needed in nearly all countries. Numerous financial crises, bank failures, and other misadventures within developing-country financial systems have imposed large costs on the poor, through their role in producing macroeconomic recessions, their negative impact on SME borrowers, losses sustained by small depositors, and the costs associated with the fact that rich stakeholders frequently do not bear their appropriate share of total losses and are bailed out by governments.

Avoiding these costs involves a range of regulations and supervisory functions. One important step is the development of deposit insurance systems for small depositors, preferably with relatively low ceilings, to avoid leakage of the benefits to larger savers who are in a better position to evaluate risk.

36. Foster improvement of the legal framework within which financial institutions operate, a change needed in many countries. For instance, there are no or only ineffective laws on collateralization in many economies, which raises the transaction costs involved in lending.

37. Facilitate and support the creation of credit-rating agencies. This can be a useful complement to financial intermediaries by helping to lower transaction costs.

38. Reduce the degree to which monetary contractions affect SMEs versus large firms. SMEs need both more equal access to credit and less instability in that access. Large firms are naturally viewed by most banks as the more important clients and safer ones. Yet, unstable credit access reduces the long-run competitiveness of the SME sector. Bearing credit crunches disproportionately has a stronger negative impact on employment than would be the case were the burden more evenly distributed. Public policy could raise credit guarantees to SMEs at times of macroeconomic stress, although this would have to be done with care.

Microfinance

39. Establish, strengthen, and expand sustainable microfinance programs. This can help the poor by lowering their vulnerability to external shocks and providing a base for small-business growth. To be sustainable, however, microfinance programs need to achieve the kind of repayment rate that successful programs have achieved, typically in the range of 96 percent to 98 percent.

40. Encourage microfinance institutions to maintain interest rates on loans at or above commercial bank rates and sufficiently above deposit interest rates to cover operational costs. Such rates are obviously needed for the program to be sustainable without requiring constant infusions of funds.

41. Consider that programs linking microfinance to productive economic opportunities—for example, supplier credit in agriculture—may warrant priority. Such linking increases the chances that microfinance will contribute to growth and sustainable income increases for the poor. Other programs, however, have been successful on the assumption that credit is fungible and that end use cannot be policed, and have paid little attention to claimed use of the credit.

42. Understand that governments can subsidize investment in, and the training costs of expanding, microfinance to the poor. As long as neither interest rates nor operating costs are subsidized, the program's sustainability is not seriously prejudiced. Subsidies for investment costs can provide incentives for expansion of microfinance to poor, sparsely populated areas and to underserved groups, and for special needs (such as the use of the harvest as collateral).

SME Finance

43. Support commercial banks in raising the coverage and effectiveness of SME lending. Most commercial banks are relatively unskilled in their provision of credit to small enterprises and overestimate the risk and underestimate the potential return. They have therefore undersupplied that market. Support and inducements for them to upgrade their efficiency and coverage can involve subsidies for training of loan officers specializing in small borrowers, and assistance in the use of information technologies to lower the cost of monitoring such borrowers. A special capital cost subsidy for expansion to unserved areas can be warranted. Here again the subsidy would be to investment costs, not operating or credit costs, to ensure that the incentives will not lead to the creation of units that cannot meet their operating costs.

44. Consider using subsidies to capital costs to induce banks to begin lending to SMEs. The support should be limited to one-off contributions to the start-up costs of entering this field. Institutions that take this step should create special departments for SME lending to facilitate the tracking of the growth, profitability, successes, and problems of such lending, and to guarantee good incentives and accountability.

45. Consider having governments provide direct financial inducement to banks to lend to SMEs. Government loans to banks for on-lending to SMEs may be warranted if SMEs are grossly underserved because banks have never bothered to explore the possibility of lending to them. It would be an infant industry or pioneer inducement. The implicit subsidies in such programs should be large enough to nudge lending behavior in this direction but not so large as to induce overindulgence. Lower costs would contribute to defraying above-average transaction costs associated with small loans and new clients but should not be allowed to support below-market interest rates.

Finance Resources

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CHAPTER FIVE
TARGETED PROGRAMS AND SOCIAL SAFETY NETS

Social safety nets are targeted programs specifically designed to protect the welfare of the poor. In this chapter, we use the terms "targeted programs" and "safety nets" interchangeably. The basic objective of safety net interventions is to reduce the extremes in poverty and inequality that are generated in a market economy either through cycles and shocks or through inequalities in the ownership of productive assets, particularly human capital. Safety net programs include cash and in-kind transfer programs, subsidies, and labor-intensive public works programs. Other examples include programs to ensure access to essential services (such as fee waivers for health-care services or heating in cold climates), or conditioned cash transfer programs to keep children in school. Targeted programs can mitigate the political and economic costs of a poverty reduction strategy based on rapid growth, which inevitably leaves behind some groups. Safety nets must be an integral and complementary part of any growth strategy intended to reduce poverty in the long run.[9]

The discussion in this chapter has five main themes. First we examine safety net programs in general, focusing on direct transfer programs designed to address both transitory and chronic poverty. These programs have the objective of maintaining the consumption of the poor during economic setbacks at a level above where they would otherwise be. The second section examines subsidies, a major category of safety net interventions. The most effective price subsidies are those on goods and services that are important components in the budget of the poor. The third section discusses programs that are designed to create employment and provide income for the poor, most notably labor-intensive public works programs. Public works programs have the dual benefits of creating infrastructure (such as local roads and irrigation works) as well as jobs for the poor.

The fourth section explores the social investment fund, a mechanism for financing small-scale infrastructure projects such as schools and water and sewage systems in poor areas. Social investment funds allow poor people and communities to become actively involved in their own development. The final section of this chapter provides recommendations on a particular subset of transfer programs: conditioned cash transfer programs. These have the dual benefits of increasing the income of the poor while providing incentives for long-term human-capital development by making the cash transfers conditional on health-clinic visits or keeping children in school.

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[9] Safety nets or targeted programs are a subcategory of the larger social protection sector, which also includes social insurance (pensions, unemployment insurance, disability insurance, and the like) and labor market interventions.

Limits to the effectiveness of safety net programs are imposed by the difficulty of effective targeting. Because of the leakage of benefits to the nonpoor and/or to corrupt officials, some supposedly pro-poor programs provide a smaller proportion of benefits to the poor than do some nontargeted programs. Targeting is simply the method chosen for directing transfers to the poor. There are many methods for targeting, including imposed or administrative methods (such as means testing, community assessment, and geographic or demographic targeting) or automatic methods, also known as self-targeting.

Spotlight on: Ukraine

Ukraine has an extensive and complex safety net system. It has been modestly successful in alleviating poverty, but is seriously inefficient in targeting and program delivery. Many of the entitlement programs and subsidies ("social privileges") are still targeted by occupational group. They are unsuited to the new setting toward which Ukraine is evolving, whatever their logic in the pretransition period. A major institutional reform is required to streamline the system, and effective targeting will be the key challenge.

Administrative targeting mechanisms have associated costs that must be considered in program design and selection. A self-targeting mechanism, on the other hand, means that the program provides goods or services that only the poor will want to consume. Examples include subsidies on low-quality wheat or rice, transportation subsidies on old buses, or employment programs that pay less than the minimum wage. Substantial leakages are difficult to avoid with subsidies on goods that the nonpoor consume, or with work that pays well for a limited effort.

Social Safety Nets

Safety nets are programs that provide cash, food, or employment as a way to protect families or individuals from either temporary or permanent shocks that would otherwise drive their income below some minimum level. Safety net programs are intended to provide a subsistence level of assistance to families whose income is temporarily reduced as a result of macroeconomic crisis, high unemployment, drought, or some other natural calamity. The programs themselves may be permanent, but the assistance they provide is intended to be temporary.

Safety nets should be distinguished from other social protection programs that reduce the effects of income volatility—such as unemployment insurance or pensions—where benefit payments are generally related to contributions. Such programs are important in any market economy but are of limited relevance to the poor. One exception is the noncontributory pension in Brazil (see Chapter Seven and the Brazil country case study). By limiting benefits to those who had reached retirement age working in agriculture for the past 10 years, it became a targeted program that worked extremely well. All but a handful of people who had been workers in agriculture were among the poor. By giving them a pension, a large share of all older poor were lifted out of poverty, especially in the northeast of Brazil. Poverty incidence dropped dramatically, in large part because of this one successfully (demographically) targeted program.

Social Safety Net Policy Recommendations

1. Establish and/or strengthen the safety net. It has become clear that market economies, particularly those undergoing processes of radical reform, need some sort of system for the protection of the poor during the adjustment process. Of course, income volatility hurts people regardless of their income or economic level, but if one believes that one extra dollar, peso, or rupee provides greater benefits for the poor than one extra dollar for the millionaire, then volatility is particularly harmful and dangerous to the poor. The marginal utility of income depends negatively on the level of income, for economists. Indeed, reducing the risk of people falling below minimum subsistence could have a positive growth effect. For example, poor families with access to safety net programs will have less need to pull their children out of school during a macroeconomic crisis or to plant low-return but stable crops rather than riskier crops with higher profits.

Most countries have some sort of private, informal social safety net system relying on family support or charities. Typically these prove inadequate and need to be supplemented by a public, formal system. The most common safety net programs are cash and in-kind transfers, subsidies, and public works programs (also known as workfare). In theory, cash transfers are preferable to in-kind transfers or subsidies because cash permits the poor to choose the optimal use of the additional resources. But cash transfers require targeting, which may be complex, expensive, and is likely to be hard to monitor and implement effectively.

2. In most countries, link in-kind or cash transfers to socially desirable activities. In-kind transfers may come in the form of food stamps or actual consumer goods, usually food. The advantage of the in-kind transfer relative to cash is that it can rely on self-targeting by making sure the commodity being given is used primarily by the poor. But in practice, both have serious drawbacks. Food stamps and actual food distribution have a fair record on targeting but are expensive to administer. In India, for example, in a centrally administered food distribution system, it cost 4.2 rupees to distribute 1 rupee of food to the poor: 1.4 rupees in administrative cost and 2.8 rupees in leakage to the nonpoor. In the Bangladesh food-for-education program, administrative costs were 59 percent of the value of the food received by beneficiaries. The most successful in-kind transfers appear to be those tied to socially desirable activities such as visits to health-care posts, school attendance, or food in exchange for work. These programs rely on self-targeting to reduce leakages, and the food or food stamps can be distributed cheaply at the health-care clinic, school, or job site. In the Jamaican food stamp program, eligibility was originally tied to visits to public health-care clinics used mainly by the poor. The result was that 39 percent of the benefits went to the bottom quintile, while administrative costs used only 10 percent of the budget.

3. Avoid safety nets that are based on unconditional cash transfers; they are too hard to target effectively in most circumstances. Direct cash transfers have a theoretical appeal as a key part of a temporary safety net, but they are in fact only relevant in relatively affluent developing countries with low levels of poverty. Three problems hinder their effectiveness in developing countries:

- Direct cash transfers require a very effective targeting mechanism based on a verifiable proxy means test of some sort to control the size of the program and leakage to the nonpoor. That has proved to be very difficult to design. One simplifying alternative is to target the program toward large families or condition the cash payments on school enrollments or on visits to health-care posts.

- If the cash transfers are intended as part of the safety net to compensate for income shortfalls because of temporary earnings shocks, there has to be a mechanism by which beneficiaries can enter and exit the program rapidly in response to changes in conditions. No country has been able or willing to design such a system, which is why public works (workfare) is increasingly being used as the key component of the safety net.

- The government has to be able to quickly and accurately identify situations that constitute a temporary crisis requiring an expansion of safety net cash payments. That is difficult to do. For example, the crisis may be precipitated by a fall in the price of a commodity such as coffee produced by poor small farmers. Is that reduction in price temporary or permanent? Should farmers switch out of coffee and produce another crop, or should the government give them cash payments to cover living costs until prices recover? The same question could arise if there were a big appreciation of the exchange rate that caused a reduction in exports and in the livelihood of exporters. Is that appreciation temporary or permanent? Should exporters be encouraged to switch to other activities or supported during a reduction in earnings that is expected to be temporary?

4. Realize that targeted cash transfers can be effective when they are limited to easily identifiable demographic groups such as the aged or disabled. Direct cash transfers in the form of noncontributory pensions for the aged and disabled are part of the safety net in several countries. Brazil is now spending about 1.2 percent of GDP on such a system. Even though it is not means-tested, the program has had a very noticeable impact on poverty (see the Brazil country case study for details). One drawback with such a scheme is that it reduces the incentive for low-income workers in the formal sector to contribute toward their retirement because they can get almost the same benefit through the noncontributory system.

5. Understand that public works programs are an important and effective component of the safety net. Also known as workfare programs, these require the recipient to exchange labor time for earnings or food. They have two key advantages: they can be self-targeted if they pay a relatively low wage, which is attractive only to those who are poor and who need work, and they can be expanded or contracted in the face of changes in economic conditions, thus serving as a good safety net. These programs are discussed more extensively below. There are examples of such programs in Argentina, Chile, India, Botswana, northeast Brazil, Bangladesh, and Honduras. To be successful, these programs should emphasize labor-intensive production activities, and, if possible, the projects themselves should benefit the poor. For such programs to work smoothly, there has to be a shelf of projects ready for financing and construction so there will not be a delay in expanding the program when a crisis occurs. In practice, workfare programs have been successful in creating temporary employment.

SUBSIDIES

Many countries use price subsidies for commodities that are important components in the budget of the poor. Examples are price controls or subsidies on food, minimum supplies of gas, electricity, and transportation. Sometimes these programs are not targeted, but they can raise the real incomes of the poor more than the nonpoor if the subsidized commodities constitute a bigger percentage of the total spending of the poor than of the nonpoor.

At one time, subsidies were used extensively to benefit the poor by reducing the costs of goods and services they consumed. The theoretical logic of the approach is compelling: Lowering the cost of goods and services the poor consume has the same effect as raising their income and improving their welfare. Unlike measures that increase the income of the poor as a by-product of raising national income, all of the benefits can flow to the poor if only their consumption or production is subsidized. At the same time, subsidies for health care, education, nutritious foods, transport to work sites, and basic housing have an advantage over cash transfers because they can encourage the consumption of goods and services that also enhance human capital and thereby the long-term earning potential of the poor. Conversely, higher relative prices for unsubsidized—or even taxed—goods and services can discourage consumption of those goods and services that do not provide such benefits or that actually can cause harm, such as tobacco or alcohol.

The earnings potential of the poor might be enhanced by subsidies for credit to agricultural smallholders and micro, small, and medium-sized enterprises and for such inputs as fertilizer and irrigation water for smallholders. The poor normally lag others in adopting new agricultural technology because they lack ready cash and cannot access credit. A general subsidy for fertilizer or water therefore benefits them disproportionately.

Spotlight on: Sri Lanka

Sri Lanka is one of the few countries in the world that significantly increased the income of the poor through food subsidies and other targeted programs. Targeting was not particularly good, but the programs were so massive that the poor benefited substantially.

In this section, we address consumption subsidies. Production subsidies are covered in Chapter Four in sections on agriculture and finance, which emphasize that the scope for effective production subsidies is much less than has often been thought. For example, subsidized credit to small farmers and to microenterprise has generally backfired. Production subsidies should be limited to situations involving the clear expectation of learning on the part of the beneficiary, such that the subsidy would be transitory.

Some countries (such as India, Sri Lanka, and Egypt) have relied heavily on extensive subsidies to implement their pro-poor strategies for much of the 20th century. Experience with subsidies, however, has shown their presumed benefits to be often elusive. Many subsidies have been inefficient because a substantial part of their benefits have not reached the poor. Indeed, some subsidies that have been justified for their benefits to the poor still have benefited the nonpoor more than the poor. In Egypt, a general subsidy on wheat flour and bread cost 1.7 percent in GDP in 1995, yet at least 60 percent of the subsidy went to the nonpoor. In Yemen, a similar subsidy cost 0.9 percent of GDP and only 28 percent went to the bottom 40 percent (see the Egypt country case study). Sri Lanka was more successful, with 60 percent of the food subsidy reaching the poorest 40 percent (see the Sri Lanka country case study). Even so, 40 percent of the subsidy went to the nonpoor and therefore did not achieve its purpose. Effective targeting is the key if subsidies are to achieve their purpose of reducing poverty at acceptable costs. Our recommendations therefore focus on targeting.

Subsidies Policy Recommendations

6. Use self-targeting subsidies to the maximum extent possible. Self-targeting subsidies have proved successful in minimizing leakage of benefits to the nonpoor. If the goods or services benefiting from the subsidy are used largely or wholly by the poor, leakage of benefits will obviously be minimal. Examples of self-targeting subsidies include subsidies on:

- Low-quality staples (such as wheat or rice) that only the poor eat;
- Inferior foods[10] that only the poor consume (such as maize or cassava in rice-eating cultures);
- Urban transport by older, slower buses that only the poor patronize;
- Construction and employment programs paying a low wage that only those desperate for additional employment and income will accept;
- Minimal quantities of electricity or water, insufficient for a lifestyle that includes power-hungry appliances or running water; and
- Dispensaries, staffed only by nurses or pharmacists, not doctors, that are shunned by the nonpoor.

Sometimes a self-targeting program can be used to distribute subsidized goods or services that are not self-targeting, as in the Jamaican food stamp program discussed above.

7. Do not subsidize scarce goods subject to formal or informal rationing. Subsidies are not efficient in benefiting the poor if the subsidized goods are scarce and therefore subject to formal or informal rationing. One benefit of the privatization of utilities is that more of the poor can get water or power from a grid, offsetting the increased cost for the few who previously had access at the subsidized price (see *Privatization and the Poor: Issues and Evidence* on the enclosed CD-ROM). Abolishing the fertilizer subsidy in Bangladesh hurt a few poor but helped a larger number who had better access, often at lower prices, because of the elimination of the profit of the powerful who had access to the rationed, subsidized fertilizer. The benefit was increased in Bangladesh because distribution margins declined when private firms could compete. There was little or no decline in the consumption of fertilizer. In Sri Lanka, however, where fertilizer was not scarce and distribution was good, the poor lost from higher prices when subsidies declined. There was also more of a reduction

[10] "Inferior" only in an economic sense—that is, foods of which less is consumed as family incomes rise. Nutritionally these foods can be superior or equal to other foods.

in consumption, although it was temporary. Where consumption declined, there was a secondary effect on the poor through declining demand for their labor.

8. Use geographic targeting, which can be almost as effective as self-targeting in reaching the poor. In most countries, poverty is concentrated in particular areas (see the case studies for Egypt, Brazil, Indonesia, and Sri Lanka). Concentrating subsidized goods and services in those areas, where the overwhelming majority of the population is poor, ensures that most of the benefits will get to the poor. This is easier to do with services that cannot be moved out of poor areas (such as subsidies for drinking water or electricity, health-care services, middle-school students, or school lunches) than for goods that can readily be sold outside these areas.

9. Do not use subsidies if neither self-targeting nor geographic targeting is possible. Administered targeting has generally proved to be not very effective because the nonpoor are able to subvert the system, thanks to their greater political power and greater ability to pay bribes than the poor. These types of subsidies are usually costly in terms of both leakage to the nonpoor and administrative costs.

Specific or administrative targeting is easier if the subsidy is limited. It is also easier if it can be supplemented by geographic and/or self-targeting. It is best achieved if local governments receive a limited allocation and need to select individual recipients within that allocation rather than receiving a larger allocation if they classify more people in their jurisdiction as poor (see the Sri Lanka and Egypt case studies).

10. Appraise the impact of a subsidy on the poor taking into account the costs to the budget and the costs in terms of distortions in consumption and production. In Sri Lanka, the cost of the welfare system, made up overwhelmingly of food subsidies, reached 6 percent of national income in some years. The same resources might have been used more effectively to help the poor in other ways (see the Sri Lanka case study).

11. Explore more efficient means of helping the poor before reducing or eliminating inefficient subsidies. Although subsidies may be inefficient, their abolition can nevertheless hurt the poor. Food subsidies can reach most of the urban poor and many of the rural poor. If massive food subsidies are ended because, as a whole, they are manifestly inefficient, the impact on the poor can be negative if they have been the only major targeted programs for the poorest 20 percent and if this group is not otherwise benefiting much from growth (see the Sri Lanka case study). The negative impact can be much reduced, while the cost of subsidies can be drastically scaled down, by shifting from poorly targeted general subsidies for such commodities as rice, wheat, sugar, cooking oil, and tea and coffee to self-targeted subsidies for low-quality staples only, supplemented by employment programs.

12. Design flexible subsidies. Technically, this is not difficult to do. Self-targeting subsidies can be allowed to expand during years of bad harvest or other crises and to contract in good years. By definition, the poor will primarily be the ones to take advantage of them. If more people are poor, there will be more demand for subsidized “inferior” foods. Similarly, with geographically targeted food, if drought or other calamity strikes a region, that region would automatically be made eligible for the subsidy. The government needs to define eligibility in a flexible manner, to provide the needed budgetary resources to cover the subsidy in bad years, and to permit the market to import additional subsidized goods if domestic production is inadequate. Using subsidized services in a similarly flexible manner is more difficult because supply cannot flexibly respond to increased demand via greater imports.

LABOR-INTENSIVE PUBLIC WORKS

Labor-intensive public works programs are part of the targeted pro-poor arsenal. They have two objectives:

- To increase the income of the poor by providing paid employment; and
- To create local infrastructure, preferably of a kind that is especially useful to poor groups (such as farm-to-market roads).

These programs differ from the larger infrastructure-construction programs that all governments fund, in three main respects. First, standard projects are carried out at the lowest budget cost, even if that requires little unskilled labor and much machinery.[11] Targeted employment programs, on the other hand, usually require that workers' wages be a substantial share of the total cost, even if that raises the budget cost or delays execution. That is the key difference between the two approaches. How high the requirement is set can depend on whether indirect labor, producing local materials, is included or not.

Spotlight on: Indonesia

Indonesia was able to affect poverty significantly through targeted programs, specifically large-scale, locally managed, labor-intensive public works programs that provided work to unskilled labor. This approach simultaneously served three objectives: providing employment and income in poor areas on a regular, long-term basis; acting as a social safety net, by expanding in areas and periods of distress; and helping reduce poverty in the long term by creating infrastructure.

Second, regular public works are usually planned by the national or state/provincial governments and executed by commercial contractors. Labor-intensive public works are usually planned, proposed, and executed by local governments or locally based committees that respond to local needs, selecting from a menu of permissible types of projects set by national or provincial/state governments. Consequently, labor-intensive public works are normally small, local projects. Some recent programs have included the poor explicitly in the decision-making process. Giving the poor a major role in making decisions is obviously a good idea from a pro-poor perspective.

Third, regular projects are selected on the basis of the most favorable cost–benefit ratio and are sited in areas with the highest return per unit cost. That often means they will be located in more developed areas. Labor-intensive public works have benefits for the poor as a

[11] Where inefficiency or corruption pushes costs above the minimum possible level or affects the technology chosen, these biases are unlikely to work in favor of employment of the poor.

principal objective and are therefore sited either throughout the country or primarily in areas of greatest poverty.

Labor-intensive public works can constitute an effective social safety net program by providing for expansion in times and areas of need. An important distinction is that while labor-intensive public works programs are part of the safety net, not all social safety net employment programs are labor-intensive public works, because not all have the creation of infrastructure as a principal objective. At one end of the spectrum are social safety net employment programs that are simple make-work schemes. They pay low wages to anyone willing to work and leave nothing productive behind except the additional welfare for these households. We emphasize that labor-intensive public works are designed to build productive infrastructure that will have economic payoff in the future in addition to the welfare benefits from the wages paid. Most typically, they involve construction of rural roads, tertiary irrigation canals or drainage works, schools or health-care centers, and local markets. In much of Latin America, labor-intensive public works come under the designation of social investment funds, are clearly distinguished from social safety nets, and emphasize the construction rather than the employment aspect of the activity.

In addition to their attractiveness as a way to give a pro-poor bias to growth and their indirect economic benefits, labor-intensive public works can be justified on strictly economic efficiency grounds in many labor-abundant countries. Market wages for unskilled workers in labor-abundant countries (such as in South Asia, Indonesia, and Egypt) are often above their marginal social product because of disguised unemployment. That is, the accounting or shadow wage is well below the wage that employers have to pay. If the cost–benefit analysis for projects is done at the accounting wage, more labor-intensive projects are justified than if the labor costs are calculated at market wages.

Programs that follow the recommendations outlined below have achieved excellent targeting, with 60 percent to 100 percent of the participants belonging to poor households in programs in India, Argentina, and Chile. In India, the labor-intensive public works program outperformed the microcredit and food subsidy programs in its targeting precision. Despite such good targeting, however, the net benefits to the poor can be a good deal less than the amount spent by the programs, for three reasons. First, the cost of wages for unskilled workers almost never exceeds 60 percent of the total program budget. Second, there can be some opportunity cost to project employment even when unemployment is high. In labor-abundant countries, this opportunity cost can be quite small if there are many workers, especially in rural areas, who are working in work- and income-sharing activities because they can find no other work. Third, there are administrative costs. It is estimated, for example, that it costs about $2.50 to increase the income of the poor by $1 in the well-regarded workfare program *Trabajar* in Argentina.

These calculations, however, ignore secondary or indirect benefits. It is impossible to quantify how much the alternative employment and income-earning opportunity provided by the program keeps other rural wages from falling below the subsistence level during periods of natural and economic calamities. Furthermore, the long-term benefits of the local public works constructed are not taken into account. A conservative estimate of the benefits of the resulting works in Bangladesh is between 3 and 10 times the total cost of the program, depending on the discount rate and the shadow price of labor used. This is a better return than on most regular public works and alone more than justifies the expenditures, even if they were not among the most effectively targeted programs. Because their targeting is very good if the wage is set low, they can also be justified on the basis of their safety net benefits.

Public Works Policy Recommendations

13. Ensure that labor-intensive public works are self-targeting through wages set below prevailing wages or minimum wages, whichever is lower. This ensures that only those really in need of additional income, the truly poor, will take the work. In other words, for the labor-intensive works program to benefit the poor, wages should not be set at or above the prevailing wage in the region. If wages are set at a rate attractive to nonpoor people, the demand for work in the program will escalate and can quickly exceed the funds available. An informal rationing system would develop in which the powerful, the politically well-connected, and those best able to pay bribes—not the poor—would get jobs in the program for themselves, their relatives, or their supporters. In short, it would become a patronage program. The pressures in this direction become irresistible as elections approach unless blocked by a firm commitment to unattractive wages. A low-enough wage will make for a flexible, self-targeting program that helps the poor in the short term and develops infrastructure that can help them in the long term, as well. The sometimes well-meaning, sometimes self-serving argument that wages below the legal minimum are exploitation must be ignored. In fact, higher wages lead to exploitation through exclusion. They are inevitably accompanied by informal rationing of jobs, resulting in rents where those allocating jobs can extract political loyalty and bribes or kickbacks, usually from the nonpoor who get the jobs.

14. Design and execute labor-intensive works programs locally, under national (or provincial) guidelines. National or provincial governments are incapable of designing hundreds or thousands of small projects adapted to local needs and priorities. When those levels of government are responsible for such programs, funds are often diverted to other programs or to private pockets before they reach local governments, much less the poor. Local bodies, either governments or separate committees, have shown significant capacity to manage local projects if they are supplied with appropriate technical assistance.

15. Make sure the national government ensures that the program meets pro-poor objectives with efficiency and with minimal corruption. To achieve this goal, national governments should:

- **Make available technical assistance** to supply the engineering and other technical knowledge often otherwise unavailable to local bodies;
- **Develop a monitoring system** that checks for diversion of funds, mismanagement, and corruption;
- **Insist that all executing bodies publicize the funds made available to them** and the physical goals of the project; and

- **Specify a menu of works that can be executed** (for example, not offices or residences, but roads or irrigation), and specify that more than 50 percent of expenditures must be used for labor.

Labor-intensive works can be executed with less diversion, less corruption, and greater efficiency and with greater benefits to the poor than can regular public works if these principles are observed. Project management and responsibility need to be local so that local knowledge is applied and the beneficiaries are induced to take responsibility, but monitoring and technical assistance must come from the outside so that the local elite does not capture the program and its funds. Public information, in large posters at the site, in ledgers kept at the local offices, and in local newspapers, makes it easy for monitors and alternative local elites to check that no substantial diversion of funds occurs. Requiring that most of the funds be used for labor ensures that project expenditures benefit the poor, not the owners of machinery.

16. Design labor-intensive public works programs to be long-term or permanent. This supports development of a portfolio and pipeline of projects ready for execution that meet the criteria of the program. Programs hastily developed during crises and abandoned shortly thereafter usually are inefficient and waste funds. The government machinery is simply not equipped to design, approve, and execute the large number of projects needed to make a dent in crisis problems, but once machinery has been developed to process and execute projects, its efficiency can be gradually improved and it can be used to execute a variety of projects.

17. Build flexibility into the design of labor-intensive public works so they become central safety net programs and automatic stabilizers. If the wages paid are low so that the program is self-targeting, it will automatically expand in bad times or in regions suffering calamity, if permitted to do so. During periods of economic crises, there will be more of the truly poor prepared to work for a low wage and interested in work under the labor-intensive works program. If some regions suffer from drought or flood, more workers will similarly seek jobs and more of the local governments will want funds for projects in their areas. If the program is prepared to fund the additional workers, it will become that rarity in poor countries: an automatic stabilizer; that is, a program that automatically expands in bad economic times without the delay that characterizes programs that need to pass the legislature. Of course, that is also the time when infrastructure projects can be executed at minimal cost, both financial and social.

18. Pay workers in cash rather than in food. The latter is inefficient, is administratively cumbersome, reduces the effectiveness of targeting, and makes it difficult for the programs to be flexible. It involves government delivering food to the work site, which requires a distribution system paralleling the market, and is inevitably far less efficient than the market would be. Moreover, opportunities abound for deterioration in food quality, theft, or diversion. If some of the workers grew some of their own food, they would then need to sell the food provided by the government to obtain cash for other needs, incurring a loss of benefits. If the program needed to expand in particular areas, a further brake would be applied by the difficulty of expanding the food distribution system. Finally, the additional food available to the country might not be the food workers on the projects would want to eat (for example, it might be wheat in a rice-eating country, or it might be a higher quality of rice than they would normally buy). Recipients would have to sell the unwanted food in the market to buy the food they wanted to eat.

19. Fund expansion of these programs from dedicated aid funds not available for other pro-poor programs. That includes a variant of the food-for-work approach. Several of the early programs were funded indirectly with surplus food aid from the United States. Because of the problems associated with distributing food to workers, the additional food was sold into the market and the proceeds were immediately spent on funding labor-intensive works. Because about 50 percent to 70 percent of the increased expenditures went for labor and because these poor workers spend 60 percent to 70 percent of their additional income to buy food, domestic prices did not decline, but workers' real income rose.

Without dedicated aid, such programs can be funded from governments' construction budgets. Governments typically spend large sums on infrastructure, so it is feasible for them to allocate some of the funds to the kind of local infrastructure projects that labor-intensive programs can build. This is often a more cost-effective way of helping the poor than subsidy programs that are poorly targeted.

SOCIAL INVESTMENT FUNDS

Social investment funds (SIFs) are central government entities that channel resources to small-scale subprojects in poor communities. The typical SIF builds social and economic infrastructure: schools, health-care posts, water and sewer systems, feeder roads, irrigation works, and so on. Some have broadened their scope to include training, microcredit, and other activities requested by poor communities. SIF operations have spread rapidly since the first emergency fund was created in Bolivia in the late 1980s. By May 2001, the World Bank had invested $3.5 billion in 58 countries, while the International Development Bank had invested almost $2 billion in Latin America alone. SIFs fall under the World Bank's Social Protection portfolio.

In most countries, SIFs were set up and originally thought of as an emergency response to increases in poverty during stabilizations, balance-of-payments crises, or deep structural adjustments. SIFs differ in objective from the labor-intensive public works employment programs described in the previous section. Although SIFs do create some employment, their chief benefit to the poor is the improvement in living conditions in poor communities that come from the operation of the projects themselves, not from the wages of the workers who build the projects. Thousands if not millions of children have been provided with better school infrastructure and basic school supplies in this manner. Safe water and sewerage systems have been built in underserved communities, and access to health care has significantly improved.

SIFs are a good instrument for improving the welfare of the poor when there are serious deficiencies in social and/or economic infrastructure in poor communities, especially in countries that also have a highly centralized government. Essentially, an SIF is a mechanism by which resources are channeled from central governments and international donors directly to poor communities. As more tax and decision-making authority devolves to local governments, both the choice and the financing of local projects can be done increasingly at the local level. A national SIF could still operate to obtain resources from international donors and assist poor communities in project preparation and selection.

A key characteristic of the SIF is the large role played by poor communities in project selection. Typically, the central SIF office, in cooperation with international donors, produces a menu of eligible project categories, generally with priorities attached, from which the poor community representatives make their selection. Beneficiary studies in many funds confirm a high degree of satisfaction with the selection procedure, but there have been operational problems, particularly in more technical projects, such as those in water and sewerage, because of the significant maintenance and operating costs that must be covered by the poor community.

In all these respects, SIFs are similar or identical to labor-intensive public works, but without the requirement that half or so of the expenditures go for labor. With the emphasis on quick action and building infrastructure, SIFs create relatively few jobs, and, of course, most of them are temporary. For the most part, therefore, SIFs have done little to help the poor earn their way out of poverty, but they have significantly improved welfare in poor communities. Most of the good jobs for skilled labor are filled by contractors from workers outside the poor community. Furthermore, in most SIFs, the wages of the unskilled are set at or below the going market wage to ensure that projects are really desired by the communities. Nor have the SIFs devoted much of their project money to income-generating projects.

Social Investment Fund Policy Recommendations

20. Don't let social investment funds replace the public sector in tasks that are the government's inherent responsibility. To do so could undermine ongoing public-sector reforms and institution-building programs. SIF portfolios will undoubtedly continue to include projects such as schools and health-care post construction, where they can be carried out more rapidly and effectively outside the government's traditional ministries. However, this should be considered an interim solution until the management and operational procedures developed by the SIFs can be transferred to the relevant ministries and municipalities.

21. Have social investment funds devote resources to training and community development. This will help guarantee that projects are sustained after construction, and it will also help poor communities obtain funds from local or national governments for community improvements.

22. Have social investment funds develop and adopt transparent project selection procedures. Mechanisms for the rapid disbursement of project grants to poor municipalities have an obvious potential for partisan patronage, particularly during election periods. To maintain public support for the funds, the selection of projects must be based on objective and defensible criteria. In addition, it is important that technical staff not be treated as political appointees to be changed with each new government. This problem has been exacerbated in many countries where fund salaries far exceed those for equivalent positions in the public and private sectors. Hence the following recommendation:

23. Don't let social investment funds pay their employees at above competitive rates.

CONDITIONED CASH TRANSFERS

Conditioned cash transfer programs provide cash to poor families contingent on their keeping their children in school, getting prenatal or preventive health care, or attending nutrition classes. These programs are a good way simultaneously to raise the income of the poor with children and to equip those children with human capital and offer them the opportunity to break through intergenerational poverty traps.

Whereas some poverty programs seek to eliminate poverty in the long run by making people more productive, and other safety net programs give poor people money or goods to increase their income in the short run, the conditioned transfer does both things at once. It not only raises the income of the poor family just as any other safety net program would, it also increases the future earnings potential of the children through the extra years of education they receive or through their better health status. Cash transfer programs have successfully achieved both of these objectives in more than half a dozen programs in Latin America and in a few elsewhere. Large programs in Brazil, Mexico, and Bangladesh have reached, respectively, 8.6 million, 1.9 million, and 2.1 million children. Recent evidence suggests that these conditioned cash transfer programs have had a significant impact on both student enrollments and educational attainment.

In Mexico, where the most careful evaluation has been done, it was estimated that the average education level rose by two-thirds of a year among cohorts in the rural areas covered by the program. In Nicaragua, average education levels at the end of grade five increased from 2.6 to 3.1 years. Positive results have also been observed in Bangladesh and Brazil. For *Progresa* in Mexico, communities that were in the program reduced poverty by 17 percent and the poverty gap by 36 percent relative to communities without the program. In Nicaragua, the Social Safety Net Program (RPS) was estimated to have increased the consumption of poor families by 17.4 percent.

The long-run impacts of the conditioned transfer programs on poverty are not observable yet because the programs have been in existence only for a short time. Yet if one takes the observed increase in average education of the current cohorts in the programs and the increase in earnings that education would produce in today's labor market, it is possible to make a rough estimate of what the impact of the extra education will be on future earnings of the children in beneficiary poor families. For Mexico and Nicaragua, two countries where enrollments are far from universal, the increase in future earnings exceeds the subsidy itself. In other words, the long-run benefits of the program to poor families are larger than the subsidy. That would not be the case if there was little increase in enrollment rates because all the eligible children were in school already.

Conditioned Cash Transfer Policy Recommendations

Conditioned cash transfers are an effective element in pro-poor programs where the poor cannot afford to take advantage of educational and health-care services.

24. Don't use conditioned cash transfers where the potential payoff to investment in educational or health-care services for the poor is not high (for example, where enrollment is close to universal). The investment component of these programs is more important than the transfers, so their logic depends on a significant payoff to that investment. They should not be turned into disguised cash transfer programs.

25. To most effectively target the poor through conditioned cash transfers, use a combination of geographic focus and locally applied means tests. A recent study of targeting performance found that these programs compare very favorably with other poverty-targeted programs. Mexico's system is typical. There, the program was limited to the rural area. Within that rural area, information from a national census was used to locate the poorest communities. Within those communities, a household survey was used to select the eligible beneficiary families. In Brazil and Bangladesh, a local committee selects the recipients rather than relying on a survey.

26. Make sure monthly payments are big enough to provide a significant incentive for families to keep their children in school or make visits to health-care posts. The payments per child average 5 percent to 10 percent of the national poverty line and 10 percent to 20 percent of the average income of poor families. Monthly payments in most programs do not vary by grade level or gender. Where the income of children who work is an important supplement to family income, benefit payments should be graduated to reflect this.

27. Realize that conditioned transfer programs are inappropriate in countries where low enrollment rates are caused by a lack of educational infrastructure, rather than a lack of demand. Conditioned transfer programs increase enrollments in countries where low enrollments are a demand-side problem rather than the result of a shortage of schools or teachers—that is, when children do not go to school because their families cannot afford to send them, not because there are no schools for them to attend. These programs make sense only where there is a fairly adequate education infrastructure already in place.

28. Understand that conditioned transfer programs are not a substitute for an emergency safety net. Conditioned transfer programs are not easy to expand in the face of a crisis. In addition, many of those who lose their income in a crisis do not have children. Therefore, these programs should be seen as complementary to safety net programs that help those who are aged or disabled or that offer employment for those who are temporarily unemployed because of an economic or climatic shock.

TARGETED PROGRAMS AND SOCIAL SAFETY NET RESOURCES

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Useful Web Sites

www.worldbank.org/safetynets
This site houses the **World Bank Social Safety Nets Primer,** launched in December 2003. The primer is intended to provide a practical resource for those engaged in the design and implementation of safety net programs around the world. Readers will find information on good practices for a variety of types of interventions, country contexts, themes and target groups, as well as the current thinking of specialists and practitioners on the role of social safety nets in the broader development agenda. Primer papers are designed to reflect a high standard of quality as well as a degree of consensus among the World Bank Safety Nets Team and general practitioners on good practice and policy.

CHAPTER SIX
CROSS-CUTTING ISSUES

This chapter presents pro-poor recommendations under the cross-cutting themes of gender, conflict, privatization, and environment. It concludes with a brief introduction to issues of governance and institutions and their relevance to pro-poor growth. Lists of resources in each section are meant to guide the interested reader to more extensive analysis.

GENDER

A gender-equitable pro-poor growth strategy is one that promotes the economic opportunities of poor women, in both self-employment and paid employment.[12] Women face greater constraints to entering formal wage labor than men, and they face various forms of discrimination when they do enter the labor force. Although some constraints to raising women's economic participation and welfare are sociocultural in origin, there are promising areas where support can make a difference, including:

- Special attention to and support for sectors and activities that employ large numbers of lower-skilled women;
- Improved access to capital through financial-sector reforms and microcredit schemes;
- Investment in timesaving infrastructure;
- Social policies to promote education, health, and child care; and
- Other measures to provide gender-appropriate social protection.

To contribute to gender-equitable pro-poor growth, these interventions must be designed with women in mind. Women will not benefit fully from improvements in the availability of credit unless an effort is made to ensure a gender-neutral distribution, nor will women benefit from increased off-farm employment unless they have equitable access. Similarly, they are unlikely to reap maximum benefits from investments in education or health care unless an effort is made to ensure that these services are sensitive to their needs. Bangladesh has been singularly successful in providing microcredit to women, with measurable impact on the well-being of clients of the Grameen Bank, a pioneer in microcredit.

> **Spotlight on: Sri Lanka**
>
> In **Sri Lanka,** poverty among female-headed households has been no greater than among male-headed households because poor women have benefited from the rapid growth of employment in two sectors that are often spurned: garment exports and migration as maids. Both provided employment to poor unskilled women and raised wages for all women in the labor market from the mid-1980s to the mid-1990s.

For women, as for men, increased labor income is fundamental to improvements in well-being. A powerful tool for enhancing the income of women is the rapid growth of activities that create new

[12] The policy recommendations presented here on pro-poor growth and gender are limited in scope to those policies that facilitate women's employment and participation in the labor market. The very broad topic of gender and poverty (and the feminization of poverty) goes well beyond this necessarily limited discussion.

jobs for women in the formal sector. Even in Muslim countries, where women face the greatest obstacles to employment in industry, the garment and pharmaceutical industries tend to employ women, and so do major parts of the electronics industry. Rapid growth of such industries has greatly increased the income of women and has done a great deal to enhance their status in such countries as Bangladesh, Malaysia, Sri Lanka, and Indonesia. In some countries, notably Sri Lanka and Indonesia, migration has also provided a significant number of jobs.

Such industries, and especially migration, have also produced a fair number of horror stories about extreme exploitation and victimization and a larger incidence of bad conditions and harassment. For the great majority of women, however, the opportunity for employment has greatly improved their situation. Indeed, evidence is beginning to accumulate that a rapid growth of industries employing women can raise their incomes significantly until, in some cases, it reaches parity with men (see the Sri Lanka country case study). This appears to be a more powerful lever than even the most effective microcredit programs, which clearly help their clients but have not been shown to measurably affect the income of women as a group.

Gender Policy Recommendations

Facilitate Women's Productive Self-Employment

Along with their domestic activities, many women from poor families are self-employed in agriculture or microenterprise. Raising incomes in either of these activities can be a viable path out of poverty for a good number of women in developing countries. In most countries, however, women's productivity and income have not attained their full potential because of market failures that inhibit productivity increases through access to productive assets, credit, information, technologies, and more lucrative domestic and export markets. Given that women are usually more susceptible than men to such market failures, it is important to improve the functioning of these markets and to develop gender-sensitive agricultural and microenterprise policies that allow female entrepreneurs to overcome the imperfections. Accordingly, it is appropriate to:

1. Improve women's access to microfinance. Improved access to and efficient provision of savings, credit, and insurance facilities can enable poor women to enhance their income-earning capacity by engaging in new productive activities and by diversifying their existing economic activities. Such access can also help women smooth their consumption and better withstand economic shocks. Constraints women face can be addressed, for example, by:

- Simplifying rules and procedures for securing credit;
- Supporting the development of nonbank financial institutions that reduce the transactions costs of lending to women; and
- Removing laws requiring married women to obtain spousal approval for bank loans.

2. Improve the provision of technology, vocational and management skills, marketing information, and advisory and business support services to women to complement the microfinance credit package.

3. Promote greater equality in property rights. Access to credit and technology is often conditioned on access to or ownership of land, and women often do not have satisfactory property rights. The joint titling of husband and spouse is often useful. Although the provision of statutory property rights is not always necessary, there must be some recognized mechanism to safeguard and enforce women's access rights to land.

4. Invest in infrastructure improvements to increase women's efficiency. Women's economic efficiency can be raised through infrastructure investments ranging from minimizing the distances women must travel to collect water and fuel, to providing electrification (which enables women to perform light-intensive work at home), to introducing laborsaving technologies that enable women to process foods.

5. Promote adult education programs and training. Technical skills are essential for entrepreneurial growth. Adult female literacy, numeracy, and education programs, targeted especially to women engaged in nonhousehold economic activities, can strengthen women's abilities in this area.

Improve Women's Opportunities for Wage Employment

A gender-equitable pro-poor strategy must focus on developing policies that increase female employment and allow productivity and wages to rise, while ensuring the provision of basic rights and working conditions. The main specific steps related to wage employment are as follows:

6. Provide appropriate policy support to sectors and activities that generate high demand for female employment. Garment exports have played this role in many countries, as has emigration of women in a smaller number of cases.

7. Promote labor legislation and policy that reduce gender discrimination. Eliminating discriminatory employment barriers through equal opportunity legislation can facilitate women's labor market participation. Labor laws that restrict the types of work women can do (such as night or overtime work) or the hours they are allowed to work should be revisited. Such regulations give firms less flexibility in the employment of women and hinder women's progress toward equity in the labor market. Labor standards should address such gender-related workers' rights as freedom from sexual harassment and freedom from sexual discrimination.

8. Develop women's overall human capital, through educational attainment and technical training. Human capital improves women's access to employment and facilitates broader occupational mobility. Equitable access to primary and secondary education is the key step to promoting long-term progress. Because formal education does not ensure remunerative employment, however, the opportunity for poor women to upgrade their skills through greater vocational training and job retraining programs can also be important. Specific interventions that should be considered include:

- Reducing the direct and opportunity costs of girls' schooling by eliminating or subsidizing the costs of school tuition, uniforms, textbooks, and stationery.[13]
- Providing flexible school hours to allow girls to perform their household and agricultural work.
- Recruiting and training more female teachers and reforming curricula and textbooks to be gender-sensitive.
- Building community schools, which reduce the time and security fears associated with girls walking long distances to school. In countries where there are separate schools for girls and boys, usually fewer of the schools are available for girls, as boys are allowed to travel greater distances than girls to attend class. Without a school within easy walking distance, girls usually do not receive an education.
- Instituting advisory services to direct women into education and training programs in sectors where labor demand is expected to grow.

9. Invest in infrastructure and public services that improve the physical safety of women working outside the home. In societies where female employment outside the home is recent, many women and their families have legitimate fears about walking or riding to the place of employment. Better lighting, better bus service, and better policing all could help.

Promote Social Protection Policies

Social protection policies should be designed to reduce the work intensity caused by the dual burden women face in combining labor market and domestic responsibilities. Women are more constrained than men from participating in the labor market because of their primary responsibility for domestic work and child care.

10. Expand the provision of child care. Lack of adequate child care can be a serious barrier to female employment, especially in urban areas of countries where other family members are no longer readily available for this function. Where a positive impact of better services on female employment can be demonstrated, possible policy solutions might include targeted child-care subsidies (vouchers) provided to poor households, and community-based child-care facilities, in which local mothers provide the care services for a modest (publicly paid) wage.

11. Develop separate support services for women migrants. Because women are far more subject to sexual harassment and exploitation than men, it is important that countries tailor assistance specifically to women. That is important if migration is to be a major element in a pro-poor strategy, especially for women.

[13] Small scholarships for girls' education have achieved success in some countries (such as Pakistan).

Gender Resources

For Further Reading

Bamberger, Michael, Mark Blackden, Lucia Fort, and Violeta Manoukian (2001). "Gender," Chapter 10 of the *Poverty Reduction Strategy Sourcebook*, Washington, D.C.: The World Bank.

Dolan, Catherine (2003). *Gender and Pro-Poor Growth*, Deliverable 18, USAID Pro-Poor Economic Growth Research Studies and Guidance Manual Activity, Bethesda, Md.: Development Alternatives, Inc., and Boston Institute for Developing Economies.

Whitehead, A., and N. Kabeer (2001). "Living with Uncertainty: Gender, Livelihoods, and Pro-Poor Growth in Rural Sub-Saharan Africa," IDS Working Paper No. 134, Brighton: IDS.

World Bank (2001). *Engendering Development: Policy Research Report on Gender and Development*, Washington, D.C.: The World Bank.

CONFLICT

Violent crises and civil wars inflict great human, social, and economic damage on the countries involved. Apart from the often large number of resulting deaths, the loss of precious physical and human capital represents a major obstacle to development in crisis and war-affected countries for years to come.

More than half of all low-income countries have experienced major violent conflict in the recent past. In 2002, the world refugee population totaled nearly 15 million, and another 22 million were internally displaced. A disproportionate share of conflict has recently been concentrated in Africa, where the poverty challenge is also the greatest. Indeed, a major cross-country determinant of the growth performance of African countries has been the presence or absence of conflict.

An economy is damaged by war through the destruction of resources, the disruption of social and economic order (including mutual trust among individuals and groups and confidence in the state), and the diversion of public expenditure from production-enhancing activities. War also reduces savings and leads to removal of assets (human as well as physical and capital) from the country. Subsequently, countries typically suffer from "war overhang" in that the cost in terms of reduced growth persists after the war. Long-term conflicts, particularly where the state disintegrates and warlords systematically and deliberately violate individual and group rights, lead to chronic poverty and the irreversible collapse of livelihoods as poor families consume their assets and retreat to subsistence production. Groups particularly vulnerable to descent into chronic poverty include the elderly and disabled, women, and children. Additionally, sexual violence is a common weapon of terror.

Poverty is generally agreed to be a determinant of conflict. This, together with the fact that conflict also causes poverty, suggests that countries can fall into a poverty–conflict trap. Ethnic and other group conflicts also often play a role.

Government leadership is essential to post-conflict recovery. All or nearly all of the standard institutions that underpin economic life are weakened during a conflict, especially those that rely on trust among people. After a conflict, the state needs to establish priorities and harmonize toward normalcy and growth.

Conflict Policy Recommendations

12. Realize that organized efforts to advance reconciliation at the local level warrant high priority in the aftermath of war. It is crucial that trust be restored and cooperation encouraged among individuals and groups so that community economic and social structures can once again become operational.

13. Formulate and implement policies with as much collaboration from marginalized and disaffected groups as possible. This is one way to foster trust in government, and, with luck, such policies will also provide quick and identifiable results.

14. Give highest priority to policies for social inclusion through pro-poor targeted programs and safety nets. Concomitant with the rebuilding of trust, these are initially more important than, and should chronologically precede, structural and macroeconomic policies for pro-poor growth.

15. Ensure that support targets demobilized soldiers, refugees, and internally displaced persons. The first group is critical because demobilized soldiers constitute an especially strong potentially destabilizing force. Such support can fall under both the safety net and development program categories.

16. Ensure that post-conflict economic policy concomitantly promotes poverty-reducing growth and addresses group inequalities. Growth that leaves any disaffected group behind may threaten future peace as much as growth that includes that group may contribute to peace. Thus, economic restructuring should be designed to increase the participation and productivity of the poor, disenfranchised, and potentially troublesome groups.

17. Focus education and adult training especially on skills required for available jobs. This contributes to growth while focusing on the constructive rather than destructive potential of the population and creating the possibility of much-needed up-front benefits.

18. Set up labor-intensive rural infrastructure programs. Given the urgent need to get as many people into productive employment as quickly as possible, programs that can create many jobs quickly while rebuilding lost infrastructure are usually an important ingredient in post-conflict programs. Other cash-for-work programs (such as in agriculture) may also be promising.

19. Ensure that donors recognize that post-conflict reconstruction is much more complex and hence riskier than similar projects in more stable environments. This requires constant monitoring to minimize negative consequences. While conflict-prone environments create opportunities for large payoffs from timely and effectively targeted aid (for example, to fund rural works programs), neither governments nor all of the powerful groups in the country will typically see poverty-reducing economic growth as desirable or in their best interests.

20. Make sure donors develop a deep, location-specific understanding of what drives conflict. Strategies must be tailored to local environments.

Conflict Resources

For Further Reading

Department for International Development (2001). "Conflict, Post-Conflict, and Humanitarian Assistance," Chapter 15 in *Poverty: Bridging the Gap (Guidance Notes),* London: U.K. Department for International Development.

Goodhand, Jonathan (2003). "Enduring Disorder and Persistent Poverty: A Review of the Linkages between War and Chronic Poverty," in *World Development* 31(3): pp. 629-646.

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PRIVATIZATION

The efficiency effects of privatization are well-known, substantial, and overwhelmingly positive. The equity effects are both less well-understood and far less uniform. The momentum of privatization, which accelerated through the 1990s, has recently slowed considerably in most if not all countries. In part, this is because the easier countries and companies have been privatized first. The slowing also stems, however, from the widespread public perception that the benefits of privatization have not been shared equitably, with the rich gaining at the poor's expense.

This perception is not broadly supported by the available empirical literature, although that literature is still sparse. The evidence available suggests that although consumers are sometimes made better off and sometimes made worse off through privatization (the former being more frequent in the small sample of cases that have been studied carefully), labor does not lose as a class (especially poor workers, who are relatively infrequently employed by public enterprises). The government almost always gains, with the biggest source of gain usually coming not from the initial sale price of the enterprises but rather from the increased tax revenues from and reduced subsidies to the newly profitable enterprises.

More analysis of privatization's effects is needed to build a more solid base from which to generalize about privatization's impact on poverty.

Privatization Policy Recommendations

21. In future privatizations, apply best practice techniques to enhance equity without sacrificing efficiency.

22. To benefit poor consumers, focus the privatization process on expanding and extending access by requiring bidders to commit to extending service at some specified rate. Carefully targeted lifeline pricing schemes can also be used to subsidize poor consumers. In either case, there will be a price in terms of reduced government gains, but that transfer may often be worthwhile.

23. To benefit poor workers, consider banning layoffs of at least unskilled workers for three years, but with a clear provision that work rules can be reformed so efficiency gains will not be imperiled. Again, there will be a price in government sale revenue, but where labor redundancy is not egregious (say less than 20 percent), the price will often be small because redundancies will be eliminated through natural attrition and the labor demands of an expanding enterprise.

24. Improve the flow of information so that the public may better understand the effects of privatization.

Privatization Resources

For Further Reading

Birdsall, Nancy, and John Nellis (2002). *Winners and Losers: Assessing the Distributional Impact of Privatization,* Working Paper No. 6, Washington, D.C.: Center for Global Development.

Jones, Leroy P. (2003). *Privatization and the Poor: Issues and Evidence,* Deliverable 18, USAID Pro-Poor Economic Growth Research Studies and Guidance Manual Activity, Bethesda, Md.: Development Alternatives, Inc., and Boston Institute for Developing Economies.

Megginson, William L., and Jeffrey M. Netter (2001). "From State to Market: A Survey of Empirical Studies on Privatization," in *Journal of Economic Literature,* June 2001: pp. 321-389.

ENVIRONMENT

Poor families suffer disproportionately from environmental degradation. They also contribute substantially to such degradation, mainly through activities in which they have little choice but to engage. Most of the world's extremely poor people live in rural areas, where a large proportion of them occupy marginal areas, such as arid and rain-fed semi-arid lands, steeply sloped and mountainous regions, jungles, forests, and marshes. In addition to whatever household lands they may possess, the rural poor are disproportionately dependent on common lands and resources for a significant range and amount of their basic needs, including forage and fodder for livestock, fuel wood and kindling, building materials, and foodstuffs. Women are especially burdened by time-consuming resource harvesting and gathering from overexploited environments.

Poor rural households depend heavily on biological productivity in agriculture and on uncultivated natural environments. Consequently, when biological productivity in a vulnerable region declines through overexploitation, poor households are likely to remain dependent on a dwindling natural resource, sometimes entering into a downward spiral of poverty and resource degradation. Even where the returns on substitutes to that natural productivity (such as fertilizers) are high, credit and capital constraints are likely to prevent poor households from making the needed investment. The rural poor are also disproportionately vulnerable to natural and human-made fluctuations and disasters, such as droughts, floods, and population displacements resulting from military conflicts.

The urban poor depend predominantly on unskilled and semi-skilled labor, much of it expended in informal-sector activities where they are highly exposed to environmental threats to health. Their living quarters often abut industrial areas, highways, railway lines, drainages, and other undesirable zones. Housing is often makeshift and offers inadequate protection or ventilation, so people spend a large part of their time outdoors in polluted neighborhoods. Consequently, the urban poor suffer a heavy environmental health burden; environmental factors are largely responsible for the stunningly high levels of morbidity found among the urban poor.

Maintaining natural capital by preventing the deterioration of biological productivity greatly enhances potential sustainable yields and the incomes of many poor families. Substituting for impaired biological productivity through alternative investments can be expensive. However, significant reductions in urban pollution can be achieved with low-cost measures and favorable benefit. Because of technological inefficiencies in production processes in low-income countries, it is often possible to identify technical improvements that would significantly reduce pollution and environmental damages while virtually paying for themselves in materials, energy, or water savings. Consequently, the claim that low-income countries must necessarily sacrifice environmental protection for the sake of economic growth often does not hold up to careful scrutiny.

Environment Policy Recommendations

25. Strive for political and macroeconomic stability. Episodes of political and macroeconomic instability weigh heavily on the poor because of their vulnerability and insecurity. Such instability usually aggravates environmental damage either because restraints on resource exploitation by the powerful are relaxed or because the poor, often as political or economic refugees, are driven to unsustainable resource uses as survival strategies.

26. Pursue legal reforms to define more clearly community resource rights. The goal should be to improve equitable access of the poor to the legal system, and to improve the ability of private and public parties to sue for compensation of environmental damages or noncompliance with environmental laws. Ensuring community rights to land, water, and forests against encroachments by individuals, corporations, or agencies of government protects the welfare of the poor directly and also makes them much more likely to manage the resources under their control in a sustainable fashion.

27. Provide incentives for communal resource management in the form of concession to the group of a resource, such as wild animal herds or forests currently owned by the state.

28. Undertake accelerated programs to regularize title to rural and urban land. Effective security of property rights in urban and rural land and resources is necessary to provide owners with incentives to invest and conserve those resources for future uses.

29. Strengthen the capacities of those governmental agencies at local, regional, and national levels responsible for managing natural resources in the public estate. This capacity-building should include training in working with communities.

30. Improve the capabilities of environmental protection agencies to carry out standard-setting, permitting, monitoring, enforcement, and public communications activities.

31. Undertake tax reforms. Tax reforms should be designed to improve the efficiency, equity, and environmental sensitivity of tax design and administration. An environmentally friendly pro-poor tax framework should (1) fully exploit the possibilities of raising revenues through taxes on goods and processes that generate negative environmental externalities, such as the use of fossil fuels, tobacco, and dangerous chemicals; and (2) tax the rents that individuals derive from natural resources, especially when their prices are high or the country is well-endowed with them. In addition to generating revenues, such taxes can discourage pernicious rent-seeking and incentives to corruption in resource management.

32. Support programs aimed at strengthening community forestry, irrigation, fisheries, and watershed rehabilitation.

33. Support agricultural research and extension programs targeted at marginal and fragile lands, such as dry lands and uplands. New technologies can be developed that are much less threatening to the environment.

34. Support low-cost sanitation, water supply, and waste management programs targeted to low-income neighborhoods.

35. Support environmental partnership programs to facilitate the effective transfer and diffusion of energy-efficient and pollution-preventing technologies.

36. Foster policy analysis of incentive reforms by in-country academic institutions, research organizations, and public agencies.

Environment Resources

For Further Reading

Bojo, Jan, Julia Bucknall, Kirk Hamilton et al. (2001). "Environment," Chapter 11 of the *Poverty Reduction Strategy Sourcebook,* Washington, D.C.: The World Bank.

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GOVERNANCE, INSTITUTIONS, AND POLITICAL ECONOMY

If historical paths and geographic settings strongly condition economic policy recommendations for individual countries, the diversity of political systems, many idiosyncratic to an individual, should induce great caution in recommending both the substance and the process of good governance. Still, just as there are essential core elements to good economic policy, especially as it affects the poor, there is a similar core of good governance outcomes that can be described, even if little is known in general about how to get there (even in a particular country).

An earlier belief in the efficacy of Western-style democracy, with a few political parties competing in national elections as the instrument of good governance rather than its outcome, has been shaken by the experience of new democracies around the world since their rapid emergence since the 1960s. Closed, one-party systems that suppress minority rights have been at least as common as open, inclusive, pluralistic systems, and neither system has been particularly successful in stimulating rapid economic growth or inclusion of the poor.

How does this reality influence our recommendations on pro-poor growth? At one level, as the Natsios Report[14] argues, little progress can be made on either economic growth or poverty reduction without at least the bare minimum of good economic governance. This minimum includes a functioning government bureaucracy, a degree of civil order that permits investors to look beyond day-to-day security concerns, and some assurance that agreements and contracts will be honored. Many countries fail to meet even these minimum standards, and USAID involvement in such countries is likely to be primarily through humanitarian assistance and conflict resolution mechanisms. Building democratic institutions as the basis for good economic governance will be premature.

Where the minimum conditions are established, more active engagement on behalf of pro-poor growth becomes feasible. Even in such countries, further institutional development is likely to be needed to encourage foreign direct investment and rapid growth in international trade. Transparency in government taxation and expenditure policies, effective efforts to control corruption, clear defense of the rule of law, voices for multiple political constituencies, and, eventually, competitive democratic processes as the basis for government formation will all lead to more rapid economic growth. In this context, attention to the pro-poor dimensions of that growth, as outlined in the specific recommendations here, can generate visible results.

Spotlight on: Indonesia

Corruption in **Indonesia** is a major factor mentioned by investors in explaining why, more than five years after the Asian Monetary Crisis of 1997–1998, private funds are still flowing out of the country when inflows would enable the economy to grow at a rate sufficient to raise wages rapidly again in agriculture and the rest of the informal sector.

All governments have strong and weak points. Experience in many developing countries has shown that, even in the midst of serious corruption and incompetence in much of the public administration, small groups of highly qualified and apolitical technocrats can have a major positive impact on the quality of public policy. This pattern is perhaps most notable in the area of macroeconomic policy. Support for the development of such technocrats should be a high-priority goal among international donors in many countries.

[14] The Natsios Report is formally known as *Foreign Aid in the National Interest: Promoting Freedom, Security, and Opportunity,* 2003, Washington, D.C.: USAID.

In many countries, clarifying and legalizing property rights could have substantial benefits for the poor. Secure property rights permit greater use of such assets for loan collateral, facilitate community or joint management of forests, and raise investment by small-scale farmers who know that the added assets will be theirs. Property rights reforms have not proved a simple matter, however. Additionally, measuring the pro-poor growth effects is a difficult and nascent area of empirical research that deserves high priority at this time. Given the early stage of such research, this guide does not advance specific recommendations on this point.

> **Spotlight on: Ukraine**
>
> Governance problems in transition economies can be magnified by the severe lack of consensus on economic direction and policy. **Ukraine's** lost decade of the 1990s has been blamed on the combination of a sluggish reform process, negative exogenous shocks, and a high level of corruption. Strong opposition to the transition from powerful groups has contributed directly and indirectly to the inertia, the lack of coherence, and the corruption.

Inherent in all successful pro-poor strategies is inclusion of the poor. This inclusion can be narrowly interpreted to mean reaping some economic benefits as part of the growth process, but a more effective interpretation would broaden the concept to include participation in local decision-making and empowerment in political processes. Giving voice to the poor on behalf of pro-poor growth will not, of course, guarantee that growth happens. In some areas of economic policy, the views of the poor as to what policy choices would benefit them may not be well-informed ones. In many other areas, however, especially matters such as local infrastructure development, the poor are often the best-informed. Without their voice, the probabilities of broad-ranging success in the attack on poverty drop off sharply.

The chapter on governance and poverty in the World Bank's *Poverty Reduction Strategy Sourcebook* is a valuable source of detail on these issues (see "Governance Resources," below):

> Problems of poverty and governance are inextricably linked. If power is abused, or exercised in weak or improper ways, those with the least power—the poor—are most likely to suffer. Weak governance compromises the delivery of services and benefits to those who need them most; the influence of powerful interest groups biases policies, programs, and spending away from the poor; and lack of property rights, police protection, and legal services disadvantages the poor and inhibits them from securing their homes and other assets and operating businesses. Thus, poor governance generates and reinforces poverty and subverts efforts to reduce it. Strengthening governance is an essential precondition to improving the lives of the poor. [p. 271]

Governance Policy Recommendations

37. Promote overall efficiency and control corruption by limiting the range of government activities to those that can be carried out well and where the government has a comparative advantage. It is particularly important to take advantage of the potential of the private sector to carry out those activities that are especially prone to inefficiency and corruption if lodged in the public sector, such as monopoly marketing of export crops (Uganda) and administrative control of the import system (Indonesia).

38. Encourage and facilitate participation of the poor in economic decision-making. This inclusion and participation should occur especially in areas where the poor are likely to be most informed, such as local infrastructure and services of particular relevance to them. This has worked well in several countries and has made programs more pro-poor.

39. Support the creation and/or strengthening of small groups of highly qualified and apolitical technocrats. Experience in several countries underlines the great positive effects good technocrats can have on performance in such key areas as macroeconomic policy.

Governance Resources

For Further Reading

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CHAPTER SEVEN
POLICY LESSONS FROM EIGHT COUNTRY STUDIES

This chapter draws lessons from the eight country case studies undertaken for the Pro-Poor Growth Research Studies project. The lessons are organized under the same headings as the guide itself, with the addition of a few extra categories. Table 1 indicates which country studies provide lessons in which particular areas, so that interested readers can consult the appropriate country study for more information on those topics. All the country studies are included on the CD-ROM accompanying this guide.

Table 1: Policy Lessons from Eight Country Studies

KEY: 0 = No Discussion, 1 = Some Discussion, 2 = Extensive Discussion/Key Topic

	Brazil	Egypt	Indonesia	Peru	Sri Lanka	Uganda	Ukraine	Zambia
Rate of Growth and Poverty								
Growth and Poverty	2	2	2	2	2	2	2	2
Economic Strategy and Poverty	2	2	2	2	2	2	2	2
Impact of Labor Intensity	2	1	2	0	2	1	1	0
Impact of Migration	0	2	0	0	2	0	1	0
Impact of Transfers	2	1	2	0	2	0	0	0
Regional and Ethnic Factors	2	0	2	1	2	0	1	0
Broad Policy Setting								
Macro Exchange Rate	1	2	2	2	1	2	1	2
Macro Inflation	2	0	1	1	1	2	1	2
Trade	2	2	2	2	2	2	0	2
Labor and Employment	1	2	1	2	1	1	1	1
Non-Targeted (sectoral) Programs								
Education and Health	1	1	1	2	1	0	0	0
Agriculture	1	2	2	1	1	2	2	2
Finance	0	0	2	1	1	0	1	0
Targeted Programs								
Social Safety Nets	2	1	2	1	1	0	2	1
Subsidies	2	2	1	0	2	0	2	1
Public Works	1	0	2	0	1	0	0	0
Conditioned Cash Transfers	2	0	0	0	0	0	1	0
Cross-Cutting Issues								
Gender	0	0	1	0	1	0	1	0
Conflict	0	0	1	1	1	1	0	0
Privatization	0	2	0	0	1	2	1	2
Small and Medium-Sized Enterprise	0	0	1	0	1	0	2	0
Environment	0	0	0	0	0	0	0	0
Governance/Political Economy	0	2	2	2	0	2	2	2

THE RELATIONSHIP BETWEEN ECONOMIC GROWTH AND POVERTY

1. Rapid economic growth is a necessary condition for sustained poverty reduction for most countries and periods. If it is high enough, it is a sufficient condition. For **all eight countries studied,** in the 10 to 50 years covered by the studies, when growth in national income exceeded 3.5 percent per capita per year, poverty declined and the income of the poor rose significantly. In other words, growth seems to be sufficient for poverty reduction, provided it is sufficiently rapid. Even lower rates of growth generally tend to reduce poverty, but the relationship is variable, influenced by other factors. For **Brazil** in the 1990s, for every 1 percent increase in national income per capita, poverty incidence declined by 2 percent. For **Indonesia** in the 30-year period 1967 to 1997, the real income of the poor increased as rapidly as per capita GDP. A simple regression shows real wages of agricultural workers increasing more than 1 percent for every 1-percent increase in the growth rate. While the explanatory power of these primitive regressions is low, and not too much faith can be put in the quantitative relationship they show, Table 2 confirms that for **all six countries** included, higher rates of growth in GDP were generally associated with higher increases in the income of the poor or greater declines in poverty. Conversely, when GDP stagnated or declined, the income of the poor also tended to stagnate or decline, and poverty increased. Indeed, when per capita income declined in three time periods each in **Peru** and **Indonesia,** the poor suffered more than the nonpoor; seriously declining incomes were usually disastrous for the poor. The few exceptions to the normal condition that growth is pro-poor can usually be explained by other factors. Most are discussed below.

2. The labor intensity of growth is a major factor in determining how much a given rate of growth reduces poverty, especially in the more labor-abundant countries. The poor generally lack assets; if they had much physical capital or much human capital, such as education, they would generally not be poor. Most of their income comes from selling their labor. If growth is both rapid and labor-intensive, the result is a rapid increase in demand for labor. That in turn results in more hours worked and rising real wages or other labor compensation and therefore rising incomes for unskilled workers, the bulk of the poor.

Rapid and labor-intensive growth most clearly characterized the post-reform periods of Indonesia and Uganda. Reform in **Indonesia** from 1966 onward was expansionary, unlike many reforms elsewhere, and was also labor-intensive. Growth was led by labor-intensive peasant agriculture and labor-intensive rural construction. Wages doubled. **Uganda's** 1992 reforms increased economic efficiency and, supported by good prices for its principal export, were similarly expansionary. Growth was led by labor-intensive peasant agriculture—first smallholder coffee growers, then food producers supplying the domestic market. The second phase, affecting food producers, was more powerful in reducing poverty because increases in income were more widely distributed among the poor. Moreover, increased food output further benefited the poor through lower food prices, the key to lower inflation. **Brazil's** growth was sufficiently rapid in the 1970s and followed a decade of rapid growth in the 1960s, to create demand for unskilled labor even though it was not particularly labor-intensive. **Ukraine** provides a different lesson, of contractionary partial reforms followed by a brief second phase (1999 to 2002) of growth after further reforms. The data are not clear, but it is possible that labor-intensive agriculture, energized by devaluation, was the primary source of growth there. Wages appear to have risen rapidly.

In **Peru** relatively slow growth in the 1970s still resulted in a significant (8.4 percent) decline in poverty incidence over nine years, because it was labor-intensive. The growth rate of the manufacturing sector was 46 percent greater than that of mining and 78 percent greater than that of GDP, thanks to a favorable exchange rate. Also, manufacturing was relatively labor-intensive compared with mining, the traditional engine of growth in Peru.

Conversely, for this set of countries, rapid growth that was not labor-intensive usually did not improve the situation of the poor. In **Indonesia**, in the early to mid-1970s, growth was rapid but concentrated in oil, mining, and timber, all highly capital-intensive, and in industries where machinery replaced labor in some processes. The income of the poor stagnated, while per capita income increased by 4.4 percent per year. In **Sri Lanka**, after its reforms in 1977, growth resulted primarily from a major construction effort, carried out by foreign contractors who made massive use of machinery in building dams and major canals. They created few jobs for the poor and therefore did little to reduce poverty. Stagnant incomes for the poor were difficult to manage politically when the economy was booming and the wealthier groups were benefiting massively.

3. Severe economic declines, including those caused by stabilization programs, are devastating for the poor even more than for other groups. Avoiding macroeconomic instability, or compensating for it when it cannot be avoided, is an important element in pro-poor growth. When countries and governments have lived beyond their means and need to carry out stabilization programs that result in a decline in per capita income, the poor suffer at least proportionately and often more than proportionately relative to the nonpoor. Declines as a result of other reasons have similar effects. **Peru** is a prime example of a stop-and-go economy. Reforms and austerity, including strong incentives for exports, would be followed by a boom that reduced poverty. Boom periods were not used to make the structural changes the Peruvian economy needed, however, and instead led to overexpansion of consumption and of government expenditures, partly financed by increased borrowing. The inevitable reckoning, which included a decline in per capita incomes (of 33.5 percent from 1986 to 1991), resulted in big increases in poverty (33 percent in poverty and 31.5 percent in extreme poverty).

The long, steady decline in the economy of **Indonesia** from independence to 1966 and of **Uganda** under Idi Amin was clearly devastating to the poor. Real wages fell by at least half for Indonesian workers in a decade, despite their having unprecedented political and economic power. **Ukraine** is yet another example. The country suffered through an extremely painful partial transition over the 1990s, during which GDP fell dramatically, probably 35 percent to 45 percent. With this crash came a significant increase in inequality and a dramatic rise in poverty, followed by a decade of stagnation. The poor were harder hit than the population in general.

Table 2: The Relationship between Growth and Poverty in Selected Countries (Annual Rates of Change)

Sri Lanka			Indonesia			Peru		
Period	**Annual % Change in GDP per Capita**	**Annual % Change in Income of Poorest 40%**	**Period**	**Annual % Change in GDP per Capita**	**Annual % Change in Income of Poorest 40% or in Real Wages+**	**Period**	**Annual % Change in Income**	**Annual % Change in Poverty***
1953-63	0.4	0.6	1953/54-63/66/67**	-0.5 to 0	-10	1970-79	0.9	-0.9
1963-73	1.8	4.4	1960-67**	-0.1	-7	1979-86	-0.3	1.8
1973-78/79	2.5	0.6	1967-71	5.9	25	1986-91	-6.7	6.6
1969/70-80/81	2.4	2.3	1971-76	4.4	0	1991-97	4.3	-1.4
1978/79-81/82	3.2	0.1	1976-81	5.7	8	1997-2000	-0.6	2.2
1980/81-85/86	3.0	-2.3	1981-87	1.9	4	1997-2001	-0.8	4.2
1981/82-86/87	2.3	1.0	1987-96	5.4	4			
1985/86-90/91	1.9	0.6	1996/97-98	-6.1	-30			
1986/87-96/97	3.2	4.3	1998-2002	1.7	17			
1990/91-95/96	3.3	4.3						
1995/96-2002	2.2	0.6	1976-96	3.0	3			

Brazil			Uganda			Egypt		
Period	**Annual % Change in GDP per Capita**	**Annual % Change in Poverty***	**Period**	**Annual % Change in per Capita GDP**	**Annual % Change in Poverty ***	**Period**	**Annual % Change in GDP per Capita**	**Annual % Change in Poverty***
1970s	5.6	-2.5	1991/92-1995/96	5.4	-3.1	1980-90	3.3	0.8
1980s	-0.3	0.9	1995/96-1999/2000	2.4	-7.8	1991-95	1.4	-0.4
1990s	0.7	-2.7				1996-2000	3.0	-0.4

NOTES:* ***A negative number represents an improvement; it is a decline in poverty incidence.***

For Indonesia: + 1960-1976 are real wages of plantation workers, the only data available, but a poor proxy for the income of all labor. Later data are the expenditures of the poorest 40 percent, deflated by the food component of the urban consumer price index.

** Note that these are overlapping time periods and do not reflect cumulative data. The data are rough estimates, subject to considerable error, particularly in the first period. The comparison therefore is between the average wage for 1953 and 1954 with the average for three years, 1963, 1966, and 1967.

++ For the years of the Asian Monetary Crisis the comparison is between the highest year before the Crisis [usually 1997] to the lowest year during the Crisis [usually 1998] and then from the lowest to 2002. Since there was an increase in the income of the poor between 1996 and 1997 and between 1998 and 1996, comparisons of 1996 with 1999 show a much smaller impact of the Crisis.

Brazil exemplifies another significant aspect of the growth–poverty relationship—that poverty tends to rise more quickly in recession than it falls in recovery. Thus, if a country goes through a recession and then recovers to its previous level of per capita income, the country is likely to have more poverty at the end of the cycle than that with which it started. This was true of Brazil in the 1980s, when the country suffered two recessions (1981–1983 and 1987–1991) before recovery brought income back to its previous level. In **Indonesia,** as well, the Asian Monetary Crisis of 1997–1998 reduced per capita income by 15 percent; it recovered very quickly but by 2002 was still 7 percent below where it had been in 1997. Poverty incidence was also up over this five-year period, and real wages of unskilled workers were down about 20 percent nationally and 30 percent in Java, where more than half the people live.

4. In the short to medium term, the poor usually lose from high or accelerating inflation, which can outweigh the effects of growth. Conversely, the poor gain from a slowdown in inflation. Reversing accelerating inflation therefore can bring quick gains for the poor, provided it is not at the cost of a recession. However, there is no good evidence that steady inflation that is considered high by some standards, but that does not accelerate, damages the poor. The poor suffer disproportionately from inflation because wages for unskilled workers tend to lag behind the rate of inflation when inflation is high or accelerating (or sometimes because prices rise especially rapidly for goods that loom large in the expenditures of the poor). In low-inflation countries, wages are usually raised only once a year, but prices are often adjusted weekly. If inflation then rises by 10 percent, by the end of the year the purchasing power of the wage, the real wage, will have fallen by 5 percent on average over the year. Even if the nominal wage is raised to anticipate a continuation of the current rate of inflation, rare in itself, an acceleration of inflation will cause the real wage to fall. Moreover, even in very high inflation economies, nominal wages are seldom raised more than every three months, so real wages will on average lag prices that rise daily. The consequences can be clearly seen in several of the countries studied.

In **Indonesia,** the devastating decline in the real wages of the poor from the mid-1950s to the mid-1960s, a decline of 50 percent or more, was caused substantially by an accelerating inflation from the single digits to a rate of 1,000 percent. The economy essentially stagnated, so it was not a decline in per capita income that particularly hurt the poor, it was the fact that nominal wages lagged behind inflation when inflation accelerated. Farmers benefited from rising prices among the goods they produced and from declining real wages; farm workers were hurt by the same decline in their pay. When inflation slowed again to the single digits, real wages doubled. During the Asian crisis of 1997–1998, inflation exceeding 100 percent in food, especially in rice, again proved devastating to the poor. A drought had reduced the food supply in 1997. Combined with capital flight, the drought precipitated a decline in national income and a quadrupling of the exchange rate, which resulted in accelerating inflation. In all of these cases, slowdowns in per capita income growth and inflation tended to reinforce each other, a phenomenon that can also be observed in other countries. While high and accelerating inflation was thus bad for the poor, reasonably steady rates of inflation of 10 percent to 20 percent (such as from 1976 to 1981) did not harm them.

Ukraine in the 1990s is an even more extreme example of the collapse of an economy when declining output and rapid inflation go hand in hand and of the devastating consequences this has for the poor. A one-third decline in GDP and hyperinflation that reached an annual rate of 10,000 percent were accompanied by a doubling of the Gini coefficient of inequality. Real wages fell to one-quarter of what they had been. Again, the poor were harder hit than the nonpoor.

Brazil in the mid-1990s is another example of the relationship in reverse. Although the economy was growing only slowly, with per capita income registering no net change between 1989 and 1998, poverty declined by almost a quarter. A major factor in this success was the reduction in inflation from nearly 2,000 percent in 1993 to an average of 10 percent for 1995–1999.

5. Effective targeted programs specifically designed to help the poor can indeed reduce poverty. Another factor that affected poverty reduction, but only in a few of the studied countries, was the existence of effective targeted programs designed to help the poor. To be effective, programs had to be massive and at least somewhat targeted in practice, not just in design. The better the targeting, the less costly the programs could be. All countries studied had targeted programs, but in only three (Brazil, Sri Lanka, and Indonesia) was it possible to discern their effect on poverty. The obvious reason why so few were clearly effective in improving the lot of the poor is that these programs have to overcome resistance from the nonpoor. They usually require taxing the nonpoor, who are politically powerful, to finance activities for the poor, who are less powerful politically. That tends to keep them small. The less obvious reason why only a few such programs are clearly effective is that it is difficult to achieve targeting, to ensure that the poor are actually the ones who receive the benefits. Again, the nonpoor are usually effective in snagging many of the benefits for themselves.

Brazil's impressive progress in reducing poverty in the 1990s has already been noted in connection with slowing inflation: despite very slow growth, extreme poverty fell by one-third, or 13 million people, and poverty by almost a quarter. A major reason was a massive noncontributory pension system. By limiting the pension to the aged who had worked in agriculture for at least 10 years and who were not in the formal-sector contributory scheme, the program achieved good targeting. Brazil is currently spending about 1 percent of GDP on this program. The program has been especially effective in dealing with regional poverty, notably in Brazil's northeast.

Sri Lanka is one of the few countries in the world that significantly increased the income of the poor through food subsidies and other targeted programs. Although not well-targeted—the poorest 40 percent received 60 percent of the benefits of the big programs, with 40 percent going to the nonpoor—the programs were so massive that the poor still benefited. As part of the pro-market reforms of 1977, expenditures on subsidies were reduced from 5 percent of GDP to 1 percent. The poor lost more than 3 percent of GDP as a result. Because the poorest 40 percent received only 15 percent of GDP, this amounted to the equivalent of a one-fifth decline in their incomes. They were also hurt more than the nonpoor by a decline of public spending on education and health care, from more than 7 percent to less than 5 percent. The shift from an interventionist and poverty-focused set of policies to a more growth- and market-oriented approach was a success in doubling growth, but it was a disappointment with respect to poverty reduction, in part because more rapid growth was achieved by a reduction of social spending and targeted subsidy programs.

Indonesia was the third country in the sample that was able to affect poverty significantly through targeted programs. It did not rely on direct transfers, disbursed as subsidies (as Sri Lanka did) or pensions and grants (as Brazil did) but on large-scale, locally managed, labor-intensive public works programs that provided work to unskilled labor. This approach simultaneously served three objectives: providing employment and income in poor areas on a regular, long-term basis; acting as a social safety net, by expanding in areas and periods of distress; and helping reduce poverty in the long term by creating infrastructure. The immediate impact on the real wages and income of the poor was significant: every 10-percent increase in expenditures on the program increased real agricultural wages by 1.5 percent and 2.4 percent, respectively, in two of Java's three big provinces. The programs were successful for much of their existence because they were self-targeting: wages were set so low that only the truly poor were willing to work on the projects financed.

Egypt's targeted programs did not reduce poverty significantly because of ineffective targeting. From 1980 to 1981, food subsidies represented 14 percent of total government expenditures in Egypt. By 1996 to 1997, the percentage of total government expenditures devoted to food subsidies had decreased to 5.6 percent. The subsidy on bread represents the largest of these and the main one in which some targeting has recently been introduced, mainly by subsidizing only bread that is of low quality, not bread bought by the nonpoor. The rest of the food subsidies cover goods, such as sugar and cooking oil, that are bought in larger quantities by the nonpoor. Such subsidies quickly become entitlements, and the politically strong middle class defends them against any attempts at reduction or better targeting. They contribute to Egypt's budget deficit and the resulting inflation. They actually hurt the poor because they use government funds that otherwise could have been used for investment in infrastructure that would have speeded growth, or for expenditures on programs that are better-targeted.

6. If targeted programs become sufficiently large, there can be a trade-off: they help the poor directly, but by diverting resources from public or private investment, they can slow growth or increase inflation and therefore hurt the poor indirectly. Targeted programs have to be financed by government. If they are financed by higher taxes, that will reduce private savings and investment, unless the taxes are designed to reduce the consumption of the nonpoor. Alternatively, the programs can be financed by reducing public investment. In either case, growth will suffer, and lower growth usually means greater poverty. If the programs are funded by increasing the government deficit, inflation will rise, and that, too, hurts the poor. Whether the trade-off is worthwhile in terms of poverty reduction depends on the following:

- How effective the targeting of the targeted programs is. If virtually all the benefits of the targeted programs go to the poor, the direct poverty reduction benefits of the programs almost certainly will outweigh their poverty-increasing indirect costs. If targeting is poor and most of the costs are incurred helping the nonpoor, almost certainly the indirect costs for the poor will outweigh the direct benefits to them.

- Whether the targeted programs only transfer income from the rich to the poor or also contribute to economic growth. If the programs contribute to growth, their growth-enhancing benefits can outweigh their growth-reducing costs and they will create a win–win situation.

- Whether they are partly or wholly funded by foreign resources that would not otherwise be available to the country, or by taxes that reduce the consumption, rather than the savings, of the nonpoor.

At their best, the experience of the case-study countries shows how well-targeted programs costing 1 percent to 2 percent of GDP can substantially benefit the poor, at minimal cost in investment. Indeed, such programs can create assets, and thereby add to total investment rather than reduce it. In contrast, several programs whose costs reached 4 percent to 6 percent (or more) of GDP proved difficult to maintain and slowed growth. They were poorly targeted on the whole, and their net impact on the poor may have even been negative.

Indonesia's labor-intensive public works program was a win–win case for much of its existence. Except during the Asian Monetary Crisis, the program was self-targeting, with wages set sufficiently low to ensure that it benefited primarily the poor. It created useful, local infrastructure, and it was largely funded by donors on terms not available for any other programs.

In contrast, **Egypt's** food subsidy program did not meet the criteria well. Although it lifted nearly one million people out of poverty, because the program was not well-targeted and thus disproportionately benefited the nonpoor, its achievement came at a tremendous cost. Indeed, between 1980 and 1997, the percentage of total government expenditure devoted to food subsidies averaged nearly 7 percent. The food subsidy program was an extremely inefficient method of reducing poverty. The program was funded out of Egypt's own resources and out of aid funds that would have been equally available for investment or better-targeted programs. **Peru** had better targeting than Egypt, and some of its programs contributed to growth, not only poverty reduction. It therefore achieved benefits to the poor at less cost than Egypt's programs.

Sri Lanka also had better targeting, with about 60 percent of the benefits reaching the poorest 40 percent, and it spent 4 percent to 6 percent of GDP on food, education, and other subsidies. As a result, Sri Lanka's programs definitely helped achieve a more egalitarian income distribution and reduced poverty. When the subsidies were sharply reduced, poverty increased. At their height, however, they did slow growth, with substantial cost in terms of opportunities for employment and earned income for the poor.

Critics who assert that welfare measures were principally responsible for **Sri Lanka's** slow growth are wrong. It is true that after the market-oriented reforms of 1977 the rate of growth increased by one-third, while targeted transfers, which had averaged 4.2 percent of GDP, were cut almost in half. Savings on subsidies helped make it possible to raise the rate of investment by 60 percent. Even after 1977, Sri Lanka spent more on welfare than most countries at similar income levels and continued to grow more slowly than most of East and Southeast Asia. However, single-factor explanations prove here, as so often, to be wrong: high welfare expenditures were but one of several major factors in Sri Lanka's slow growth during the 50-odd years since the country's independence. The rigidities and inefficiencies of extensive government controls over the economy were important too. Insurgencies in the south were a smaller factor, whereas the riots of 1983, followed by civil war and terrorism, slowed growth massively. Then, in the 1990s, defense expenditures exceeded welfare costs. The civil strife cost Sri Lanka about 2 percentage points of growth through lower investment and greater defense expenditures, while the welfare state cost about 1 percent in the 1990s. Sri Lanka could have achieved a much higher growth rate with no cuts in targeted subsidy programs by going as far as other Asian countries in reducing rigidities and inefficiencies and by reducing the cost of civil strife.

From a pro-poor perspective, one needs also to calculate the trade-offs for the poor. A transfer of 4 percent of GDP from welfare to investment raised the growth rate by less than 1 percent a year in 1977. It would take 20 years at this higher rate of growth to compensate the poor for their share of the 4 percent of lost transfer payments—not a very attractive trade-off for the poor.

Brazil had a well-targeted program for the rural poor, as discussed above. At a cost of only 1 percent of GDP, it had a remarkable impact on poverty. However, Brazil also had a large formal-sector retirement system that was ineffective in helping the poor and costly in terms of growth. Contributory pensions for formal-sector workers alone cost 8.5 percent of GDP and did little to help the poor. In total, Brazil is now spending more than 20 percent of GDP on social programs, which has increased the public-sector deficit, soaked up private saving, and probably crowded out investment. The effectively targeted programs, however, are not at the heart of the fiscal problem; they have had a major positive impact on poverty, at a cost of less than 2.5 percent of GDP. Brazil now confronts a difficult dilemma: how to fund its social programs at minimum cost in lower growth. One proposal is to make the nontargeted formal-sector and government social security systems less generous for retirees, most of them nonpoor, but this is sure to generate strong opposition from affected groups. The alternative would be to increase formal-sector taxes, which would aggravate crowding out of investment and therefore lower the growth rate.

Another problem stems from the regional concentration of poverty: 70 percent of the indigent population is in the northeast. Poverty-reducing transfers therefore inevitably involve significant transfers from the southeast to the northeast, raising questions about what is politically feasible and whether tax increases in the southeast would affect the growth rate of that dynamic area.

7. Migration contributes importantly to poverty reduction in a few countries. One important benefit is often overlooked and not captured in the growth rate: by reducing the labor supply, particularly of unskilled workers, migration helps tighten the labor market and raise labor income. Migration is an important part of globalization for a handful of countries, including two in our sample. There have been significant waves of emigration from **Egypt** to work abroad since the oil boom of the 1970s. By the early 1980s, 10 percent to 20 percent of the Egyptian labor force was so engaged, mainly in the Persian Gulf region. Large-scale movements of workers have been the norm in response to political factors, such as the two Gulf wars, and to economic change, most notably in the price of oil. The impact in Egypt is great. When there is a massive flow of Egyptian labor to the oil-rich states, the labor market in Egypt tightens and real labor income rises. Between 1980 and 1983, the number of Egyptian workers abroad more than tripled and real wages rose by approximately 33 percent. Most migrants were unskilled workers from rural areas; their remittances generally went directly to poor rural households. They also fueled a construction boom in rural Egypt. With labor supply reduced by migration and demand for labor increased by the construction boom, agricultural wages rose dramatically. When the flow is reversed, the consequences for the poor can be dire, as in 1989, when a decline in the number of workers abroad contributed to a fall in real wages of nearly 40 percent.

From 1977 on, **Sri Lanka'** reforms permitted and even encouraged migration. As a result, nearly half of the net increase in the labor force went abroad from 1978 to 2002, rather than exerting downward pressure on wages. Two-thirds of the migrants were women, the great majority of them maids, so benefits accrued particularly to poor unskilled women. Another benefit, remittances, became of increasing importance over time, contributing one-fifth of export earnings in the most recent period and adding directly to family income, in many cases of low-income groups. At their peak, remittances exceeded 5 percent of GDP.

One reasonable assumption is that remittances would constitute an increase of 20 percent or more in the average income of the poor. As in Egypt, remittances in Sri Lanka sparked a boom in construction and local businesses, which absorbed another part of the increase in the labor force. The increase in migration therefore was a major factor in raising incomes of the poor in the 1970s and in their stagnation in the early 1980s, when migration slowed or reversed.

The volatility of migration imposed special problems of economic management on **Sri Lanka** and **Egypt,** which neither country handled particularly well. For **Egypt**, the problem was especially severe because some of the factors that determined migration flows also affected other major sources of income. The long-term outlook for migration is uncertain, but probably not more than for other export industries. Because the migration of people is, by definition, labor-intensive —hardly anything is more labor-intensive, in fact—it can contribute substantially to poverty reduction.

8. Growth and poverty reduction are more often complementary than conflicting goals. This is true, first and foremost, because higher rates of growth tend to benefit the poor, as already discussed. More specifically, policies that reduce distortions and value labor, capital, and foreign exchange at close to their market prices are good for both growth and poverty reduction. In labor-abundant, foreign-exchange, and capital-scarce economies, such policies will lead to increased employment of the most abundant resource, unskilled labor, good for the poor and for growth. Additionally, policies that prevent high and increasing inflation also tend to be good for both growth and the poor. There are a host of other specific policies that benefit both growth and poverty reduction, including facilitating migration and labor-intensive public works and upgrading and extending education and health-care services. An egalitarian income distribution and increased incomes for the poor can also help diminish unrest, insecurity, and the riskiness of investment, which in turn encourages investment.

Sri Lanka remained a calm and peaceful country despite some 30-odd years of slow growth in the income of the poor. Because the poor felt that the government was looking out for their interests, an egalitarian ethos existed, and the poor received substantial benefits from the targeted programs. Conversely, one factor in the disaffection of the ethnic Tamil minority, which led to civil war, was the perception that the benefits of the huge dam projects, launched in the late 1970s, and of development more generally, would overwhelmingly go to the majority ethnic community. The southern insurrection, which interrupted the calm briefly in the '70s, was also based on economic grievances among unemployed youths who felt they had little chance for good jobs and little future.

In **Indonesia,** the perception of increasing income disparities and the disproportionate suffering of the poor during the rapid inflation of the early 1970s and late 1990s contributed to rioting. This, in turn, led to capital flight, a primary cause of the depth of the crisis of 1997–1998.

It is sometimes argued that greater inequality fosters growth because it results in higher rates of domestic savings and that therefore steps to reduce poverty by reducing inequality are bad for growth. Rates of saving seem to be determined little by the concentration of income and primarily by the rate of growth and by policies that foster investment. For **Indonesia,** gross fixed-capital formation, the only reasonably reliable indicator available, averaged only 8 percent during the period of stagnation in the 1960s. Once growth picked up, gross fixed-capital formation also shot up, reaching 20 percent less than a decade later. Capital inflows accounted for only one-third to a quarter of the 12-percentage-point increase. The size of government deficits was the major policy variable that influenced public savings.

9. That the gender dimension of poverty is important has received lip service in many countries, but this view has had little impact on actual policies. The composition of growth can affect female poverty, which tends to be high.

Government poverty programs in several of the countries studied reflect concern for the "feminization of poverty" and mention the importance of paying attention to the gender dimension of poverty. However, women's ministries in countries such as **Egypt** and **Indonesia** seem mostly concerned with specific projects and programs to train women and to deal with issues such as domestic violence rather than with framing major economic policies to benefit women. Yet it is clear from **Sri Lanka's** experience that the sectoral composition of growth can have a substantial impact on women. This is discussed under "Cross-Cutting Issues" below.

MACROECONOMIC POLICIES AND TRADE

Effective macroeconomic management has been a key ingredient in successful poverty reduction efforts. One immediate objective of macroeconomic management is to prevent the acceleration of inflation, which is also important to avoid deterioration in the income of the poor in the short term. That is why control of money supply and the government deficit matter directly to the poor. In the long term, however, poverty reduction depends primarily on rapid, labor-intensive growth, which in turn also depends heavily on effective macropolicy. In this respect, a major element in their success or failure for the eight countries studied was successful or unsuccessful exchange-rate management. Other policies that mattered were those with respect to trade and capital flows, taxes and government expenditures, and credit management.

10. Exchange-rate policy was in many countries a key to rapid growth and poverty reduction. In the earlier stages of development, exchange-rate policy was important for successful import substitution and growth in some traditional exports and later influenced the growth of nontraditional exports. The exchange rate is such a powerful tool that even governments with limited management capacity and high levels of corruption can manage it to achieve an efficient mix of domestic production, imports, and exports. The exchange rate has proved to provide a powerful, general incentive for production of goods in which a particular country can compete. Because, almost by definition, the countries we studied have lower labor costs and more abundant supplies of labor than do high-income countries, an appropriate exchange rate will often stimulate the growth of relatively labor-intensive goods (and services). Specific trade policies are frequently distorted by nationalist pressures favoring capital-intensive activities in which the country can compete only by dint of heavy subsidies. Trade policies are also distorted by corruption and political pressure from special interests. Nonetheless, an appropriate exchange rate will provide incentives for the production of exports and import-substitution goods and services in which the country is most competitive.

The case is clear in the countries we have analyzed, as it was in earlier success stories in East Asia. **Indonesia's** story is especially compelling. The country's technocrats did an outstanding job managing the exchange rate; though allowed to float with virtually no restrictions on capital movements, it was managed nevertheless, mostly indirectly. In the period after the reforms of 1966, the rate was sufficiently low that, together with a plethora of tariffs, subsidies, and some remaining quantitative restrictions, it encouraged the legal export of plantation crops and oil and the domestic production of such labor-intensive import substitutes as yarn, cloth, and other consumer items, as well as such products as cement and fertilizer. As in other countries, this process largely ran out of steam as the demand for the protected domestic market was satisfied for technologically rather simple and labor-intensive goods. Like other countries, Indonesia then moved into capital- and technology-intensive goods, including aircraft and steel production, which had to be heavily subsidized. Unlike some other countries, however, Indonesia also devalued its currency sufficiently, notably as part of the reforms of 1986, and adopted other needed reforms to develop a rapidly growing, export-oriented, labor-intensive manufacturing sector. Manufactured exports increased from a negligible amount in 1972 to $1 billion in 1982 to close to $20 billion in the early 1990s.

Employment in the export industries increased commensurately. In addition, the rapid growth of that sector generated more jobs for unskilled workers in construction, trade, services, and transport. Not surprisingly, manufacturing was the leading sector in reducing poverty during this stage of development.

The decision to let the exchange rate fall radically during the crisis of 1997–1998 imposed heavy costs on Indonesia, and especially on the poor, because it sparked high rates of inflation and loan default. At the same time, it allowed the economy to adjust relatively quickly by stimulating a spurt in exports, despite political turmoil, the perception of rising corruption, and an increasingly negative atmosphere for foreign investment. Greater control over capital flight would have helped, but once it was decided—probably realistically—that the system could not effectively control capital movements, allowing the exchange rate to do its equilibrating work may have been the only sensible approach.

Exchange-rate management in **Peru** has had to contend with Dutch Disease problems: the mining sector, which is capital- and skill-intensive, dominates exports. It is competitive at an exchange rate at which many labor-intensive sectors cannot compete with imports or with other countries in the world market. When mineral prices are favorable, the economy can grow rapidly, with jobs created in trade and services. The exchange rate appreciates, and employment declines in agriculture and industry, which have become uncompetitive, as happened to some extent in the 1990s. The benefits to the poor were limited because demand for their labor increased little. When mineral prices declined at the end of the decade and the boom ended, the poor were hard hit. One response would have been to have raised incentives for exports and for growth in manufacturing, nontraditional agriculture, and modern services by maintaining an undervalued exchange rate at least for a period of time. The potential for such a stimulus was demonstrated in the one period when it was given a sustained chance to operate, the second half of the 1970s. Peru did achieve rapid growth and reduce poverty at that time. More frequently, it failed to manage the exchange rate to provide adequate incentives for nontraditional exports. As a result, it also failed to achieve sustained growth in employment and wages and to reduce poverty, a central failure of Peru's strategy for growth and poverty reduction over the longer run.

Realizing the potential benefits of a promotional exchange-rate policy can, undeniably, be tricky. It is bound to increase prices of tradable goods. Rising prices and lagging wages exert downward pressure on real wages in the short term. Over the long term, however, the increased demand for labor contributes to real wage increases, especially if other measures are taken to limit the inflationary effects. In **Peru's** experience in the '70s, however, inflation worsened and the real incomes of the poor fell by more than necessary to restore external balance. Those negative effects on the poor of the devaluation were caused, or aggravated, by two avoidable errors: devaluation was prolonged past the need for it, and monetary policy failed to provide the necessary restraint. One legacy was the mistaken conviction that devaluation necessarily worsens inflation. It clearly can do so, but it need not, as suggested by more positive outcomes in other countries.

Egypt provides another example of the failure to manage the exchange rate well in the face of Dutch Disease problems. Like Peru, Egypt had a period of growth (though at a modest rate of 2.2 percent per capita) after the reforms of the early 1990s, but the country operated with an overvalued currency[15] and its export industries failed to grow significantly or to provide jobs for the growing labor force. Sustainable poverty reduction will require significantly expanding the country's exports of labor-intensive goods (which include tourism in Egypt). Exchange-rate management will need to be a key tool for industries not based on raw materials.

Uganda during the 1990s recovery is an example of successful exchange-rate management, but this time in an economy that continued to rely on agricultural production as its mainstay. A favorable floating exchange rate, part of its successful structural adjustment program of the 1990s, facilitated Uganda's recapture of a larger share of the coffee market, which it had lost during the period of civil strife and mismanagement. Later, the floating exchange rate helped in the expansion of peasant food production for the domestic market by making it possible for these producers to compete with imported-food producers. Both developments were central to the reduction in poverty that took place. In contrast, one of the reasons **Zambia's** structural adjustment program was unsuccessful was the inadvertent and ill-timed overvaluation of the early 1990s, soon after the program's inauguration, which constituted a drag on the key noncopper sectors.

Ukraine offers another example of the importance of the exchange rate, especially if a country has substantial underutilized industrial capacity. After a very painful and massive decline in income during the 1990s, Ukraine's economy finally began to recover. The reforms of 1999–2000 helped, as did good crops and perhaps the normal cyclical upturn, but the accidental devaluation of the currency and the impact of Russia's growth on Ukraine's exports were the major factors (accidental in that the devaluation was the result of Russia's own devaluation, with Ukraine's currency tied to Russia's). They provided a strong stimulus to the production of both exports and import-competing goods.

The experience of **Ukraine** demonstrates why the exchange rate is such a powerful tool in countries that have significant underemployment as well as unemployment, as most labor-abundant low-income countries do. There is often also substantial underutilization of capacity. In Ukraine, this was the result of the sharp decline in domestic demand and in demand from Russia. Other countries have the same experience after a recession—as in **Indonesia** after the crisis of 1997–1998. Yet even in more normal circumstances, factories often operate only one shift and six days a week because it is more costly to operate additional shifts and days. Devaluation makes it profitable to operate additional shift days and otherwise to put idle capacity to work as the country becomes competitive in the world market. This "activation effect" can rapidly increase output by 10 percent or more in industry without much additional investment.

[15] Defining overvaluation is less clear for Egypt than for some other countries. Foreign aid has been very large and creates many of the characteristics of a Dutch Disease problem: an exchange rate at which large parts of industry and agriculture cannot compete in the world market. Aid at this level is not ensured for the long term. Had the exchange rate been lower and had other appropriate steps been taken, Egypt could have benefited substantially from employment creation in labor-intensive exports.

The experience of several of these countries shows that economic liberalization does not rule out the management of exchange rates. **Indonesia**, **Sri Lanka**, **Egypt**, and other countries could still substantially influence their exchange rates.

11. Dutch Disease countries, with large foreign-exchange earnings from high raw material prices or from massive foreign capital inflows, confront a complex problem in managing their exchange rates if they are to derive long-term benefits from these windfalls in terms of both growth and poverty reduction. These problems can be managed, as noted in the case of **Indonesia**. However, it is likely that Indonesia was the only populous oil-rich country that managed to retain competitive agricultural and industrial sectors through two oil booms and to rapidly expand manufactured exports when the second boom faded. The other Dutch Disease countries in our sample, **Egypt, Peru,** and **Zambia**, did not succeed in this respect. In these countries, several growth spurts were financed by temporary factors, such as substantial improvement in the terms of trade and/or short-term inflows of foreign capital, and could be prolonged by the rundown of reserves or by massive borrowing. These temporary factors eventually come to an end, however, with dire consequences for the poor the usual result. **Peru**, **Egypt**, and **Zambia** all had such booms. **Zambia's** was long-lasting, as copper production expanded and copper for decades remained by far the dominant export. The crisis, when the price fell sharply in the mid-1970s and then exhibited an erratic downward trend from then till the present, was all the harder to deal with as the economy had been very much built around this product. The stop-and-go nature of mineral-fueled booms is also a principal factor in **Peru's** unsatisfactory performance with respect to growth and poverty reduction. **Egypt's** spurts were also short-lived, usually due to an oil boom that increased oil and Suez Canal revenues, produced massive remittances, and stimulated tourism. Industrial exports there dropped and agricultural production struggled. When oil prices fell or conflict sharply reduced oil production, all four sources of growth sharply declined and Egypt struggled with a difficult adjustment problem.

Indonesia's success had three elements. First was the management of the exchange rate, through frequent small adjustments and periodic large devaluations to keep pace with its higher rate of inflation, with the aim of keeping the country's exports competitive. Indonesia did not hesitate to accumulate foreign-exchange reserves for years at a time if this was a consequence of a deliberately undervalued currency. Second, there were a whole host of subsidies, both direct and indirect, with the same purpose. On the import side, tariffs and some, largely hidden, quantitative restrictions were the principal means. On the export side, the principal subsidy for a long period was cheap credit. For a period, an effective drawback scheme refunded tariffs and taxes on imported inputs for export industries. These could be manipulated to provide a hidden subsidy. Many exporters operated in duty-free areas or used bonded warehouses, where they saved on tariff and tax costs and where labor laws often did not apply. Policies kept real wages both stable and low in dollars or yen.

Finally, Indonesia invested part of its first windfall in a labor-intensive public works program, which provided income and employment to the poor in the short run and left behind an improved infrastructure in the long run. The improved rural infrastructure was the basis for more rapid agricultural and rural development. The second oil windfall went in part for the rapid achievement of universal primary education and expansion of secondary education, an important element in the development of manufactured exports. Both uses of the oil windfalls expanded nontradable production, and both windfalls were also used to support the wasteful but effective subsidies to parts of industry and agriculture that were temporarily uncompetitive as the result of the appreciation of the exchange rate, as already discussed. Both windfalls thus were used in part to expand the productive base to put Indonesia in a better position to deal with the end of the windfall.

Indonesia's plethora of special subsidies—literally hundreds of tariffs, special deals, and quantitative restrictions—made for substantial inefficiencies and spawned a web of collusion, corruption, and nepotism. A simpler system with greater use of an undervalued exchange rate and one of two rates of taxes and tariffs would have been preferable and created fewer distortions, but Indonesia's system was more attractive politically and did allow exporters and import-competing industries to survive when the currency was overvalued because of temporary windfalls from high oil prices. The cost in inefficiency was probably worth paying once one considers the decline in poverty that resulted.

12. The inflationary pressures from a modestly undervalued exchange rate are far more manageable than the costs in slow growth and increasing poverty of an overvalued one. An undervalued exchange rate can continue for a long time, whereas an overvalued one is almost inevitably self-limiting, with the danger of a short-term crisis when the country runs out of usable reserves or borrowing capacity. Traditionally, the main source of periodically overvalued currencies has been the combination of a fixed exchange rate and an internal rate of inflation greater than that of one's trading partners. Even where the fixed exchange rate is not used as an anchor against inflation, overvaluation tends to arise simply through a tendency not to devalue until the exchange rate is considerably overvalued. Where a fixed exchange rate has been a key component of the battle against inflation, the inclination to allow overvaluation has been that much stronger. Although these sources of periodic (or even chronic) overvaluation still persist in some countries, a major new factor in overvaluation in the era of liberalized capital markets has been unstable capital inflows, the source of overvaluation in the late 1990s in **Peru**, for example. In many settings, the investment- and growth-repressing effects of overvaluation can outweigh any benefits from the inflow of capital (even before allowing for the pernicious effects of sudden outflows), and thus lead to the paradox of less investment occurring just when there is greater access to foreign resources.

In countries where the disincentive to investment is concentrated in labor-intensive exports, the negative impact on the poor will tend to be greatest. **Egypt** clearly falls into this category, and **Peru** may.

We must recognize that the causal chain from devaluation to inflation to an increase in poverty is a legitimate source of concern. In **Sri Lanka**, the tripling of the rate of inflation after the market reforms of 1977 contributed to an increase in poverty as wages lagged price changes. The increase in inflation was caused by exchange-rate depreciation and other reforms. In **Peru**, **Uganda**, and **Zambia** as well, devaluation led to inflation as a result of its upward pressure on the prices of tradables. Up to a point, inflation can be thought of as a cost of achieving the right price incentives for producers, with negative effects on the poor of accelerating inflation offset by increased employment and wages stemming from the competitive gains the devaluation has brought.

The experience of **Brazil** shows how inflation can hurt the poor whatever its cause. Rising inflation there coincided with a sharp increase in both poverty and inequality after 1987, and the end of inflation in mid-1994 was followed by a 25-percent reduction in poverty over five years. In this case, devaluation was less important than a built-in inflationary dynamic that the Cruzado Plan of 1986 tried unsuccessfully to break.

The inflationary threat of devaluation can be minimized by compensatory policies, as in **Indonesia**. In the three years before a 60-percent devaluation in 1986, inflation averaged 8 percent; in the next three years, inflation actually averaged a bit less than that, while nonoil exports surged at 25 percent per year. Two measures kept inflation low: stabilizing the price of rice and lowering tariffs on imported consumer goods. The government's rice stabilization agency fed enough rice into the market to contain the increase in its price far below the 60 percent of the devaluation. Government absorbed any losses, a price worth paying to keep inflation in check. In addition, lower tariffs largely negated the effect of the devaluation for imports of goods widely consumed. This was thus a partially compensated devaluation. A fully compensated devaluation would have kept most domestic prices unchanged by a combination of taxes on traditional or primary product exports, lowered tariffs, and, if necessary, subsidies on mass-consumption imports, with the impact of the devaluation hitting nontraditional exports, semi-luxury and luxury imports, and capital transactions. Although fully compensated devaluations are difficult to carry out in practice, the Indonesian experience indicates that partially compensated ones can be feasible and effective in limiting inflation.

Although the costs of devaluation in terms of inflation proved significant in other countries, so did the benefits in terms of greater production and employment, especially for unskilled labor, the most abundant resource in all countries. As a result, there were substantial benefits in terms of poverty reduction.

13. Managing capital flows has proved difficult, and the eight countries studied do not provide clear lessons on how to achieve such management. Both **Peru** and **Brazil** benefited from capital inflows, which raised their growth rates and helped reduce poverty. Because these inflows were generally temporary, however, as in **Peru,** they aggravated the Dutch Disease problem when inflows stopped. **Indonesia's** problem was with massive capital flight, a major contributor to a sharp drop in GDP during the Asian crisis of the late 1990s. Several of the countries might have benefited from measures to limit short-term capital inflows, if that could have been done without harming long-term flows of foreign direct investment. They could also have benefited from measures to slow capital flight to give the country more time to adjust to capital movements, again if such measures could have been adopted without harming investment flows. The major reason the countries did not adopt such measures was that it was not easy to devise measures that encouraged desirable flows while discouraging undesirable short-term ones. For **Indonesia,** there was another reason not to try such measures: the fear that they could not be effectively enforced and would only lead to more corruption. Discretion seemed the better part of valor. Taking account of the capacity to implement regulations before deciding to impose them is clearly a wise, albeit rare, step.

14. Large countries can temporarily achieve high rates of growth and satisfactory rates of poverty reduction with leading sectors, including such labor-intensive, nontraded activities as residential construction. Large countries with a large domestic market, such as **Brazil** and **Indonesia,** have a greater potential for growth than small economies based on the expansion of domestic demand. Several periods in Brazil and the post-crisis years in Indonesia were, at least in part, based on a strategy of having nontradables as the leading sector. In both countries, much of the growth of nontradables took place in labor-intensive sectors, including residential construction. It was therefore poverty-reducing.

Before long, such a strategy inevitably generated increased demand for imports. Increased imports can be financed temporarily from increased capital flows, increased borrowing, or the running down of foreign-exchange reserves, but these expedients run out of steam sooner or later. Ultimately, increased imports required increased exports to pay for them, and that in turn required an exchange rate that provided the needed incentives. Historically, therefore, most of the rapid growth in the last half century has been export-led, after an initial period in which growth was primarily supplied by agriculture and by import-substituting industrialization.

Indonesia dealt with the crisis of 1997–1998 in part by inflating domestic demand through a substantial budget deficit as the country emerged from the crisis. Another vehicle was the expansion of labor-intensive public works, partly funded by the World Bank, partly by the budget. The result was a domestic boomlet, particularly in residential housing construction and consumer goods. A substantial fraction of the additional production did not require capital-intensive investment, but came from labor-intensive domestic factories, with unused capacity due to shrunken foreign markets. A flexible exchange rate kept the foreign trade accounts in reasonable balance. However, by 2003 there was evidence that this strategy was coming to an end—some of the larger exporting industries were in real trouble, and a shift to reemphasize exports was becoming essential. It remains to be seen whether Indonesia can make that shift.

15. Trade-related policies usually mattered less than exchange-rate policies in the countries studied, but they were significant to important labor-intensive sectors and were an essential component of reforms in countries with government-controlled economies (for instance, where import licensing played a major role). Trade policy changes, generally in the direction of liberalization, had strong and identifiable results in fewer cases than did exchange-rate policies in the countries studied. In **Brazil,** the 1985 tariff structure was particularly harmful to rural families and to the urban unskilled. Trade liberalization from 1988 to 1994 lowered inequality, increased output, and lowered poverty. The liberalization was one factor contributing to falling poverty during the 1990s in Brazil. **Egypt,** with its proximity to Europe and its low labor costs, should readily have become part of the new pattern of global production in which multinational companies outsource production of inputs globally. It has been argued that its failure to do so has in part been due to tariffs that are structured to deny local producers access to internationally priced inputs. If so, this clearly hurts the country's ability to develop a labor-intensive exports sector.

For **Indonesia,** trade liberalization was an important part of every reform process. The abolition of import licenses in the massive reforms of 1966–1968 eliminated a major source of inefficiency and corruption and contributed to ushering in a 30-year period of 7-percent annual growth. An important part of the 1986 reforms was to free imports of inputs used in the production of exports and to lower tariffs substantially for all imports. Freeing imported inputs fueled rapid growth in labor-intensive manufactured exports, the lead sector in rapid growth and continued poverty reduction in the subsequent decade. Lower tariffs were necessary to compensate for a major devaluation and to ensure that devaluation did not quickly translate into higher inflation, with resulting increases in poverty and erosion of the benefits of devaluation. Abolition of import licenses and lower tariffs were also an important part of the **Sri Lankan** reforms of 1977 and the country's resulting growth spurt.

In **Uganda,** policy steps that removed indirect barriers to trade were important, although they did not fall into the usual tariff-and-trade category. A key reform facilitating agricultural growth and poverty reduction was the termination of state marketing boards. This allowed a much higher share of world prices to reach peasant producers and to stimulate output and incomes.

Government intervention in agricultural exports has often damaged growth and poverty reduction. Marketing boards in Africa are a prime example. Sooner or later, and mostly sooner, they became rife with nepotism and inefficiency and imposed hefty margins that discouraged production, exports, and employment in the production of labor-intensive crops.

Zambia's experience with trade liberalization calls into question the wisdom of failing to maintain some protection in the context of an appreciating and ultimately overvalued exchange rate and of having trading partners that do not comply with trade agreements. The total removal of protection as part of the country's early 1990s structural adjustment program hurt the competitiveness of Zambian exporters. Clearly, trade policy, like other important policies, should not be made or implemented in isolation.

16. Policies conducive to investment (including foreign private investment for countries substantially reliant on it) are an important element in macroeconomic policy for growth and poverty reduction. The success stories in medium- and long-term poverty reduction in labor-abundant countries—most notably **Indonesia** and **Uganda** in our sample (and **South Korea, China, Taiwan, Malaysia, Singapore,** and, earlier, **Japan**)—all rely heavily on the rapid growth of labor-intensive exports to the world market, the only market large enough to generate the employment needed. Breaking into that market requires foreign expertise and reputation, as well as foreign capital. In **Sri Lanka,** the garment industry, a large part of the success in reducing poverty among the country's women, depended heavily on foreign private investment in its initial development. In **Uganda's** case, where coffee production was in the hands of small peasant farmers, the expertise and connections needed came only in marketing. In addition, it was pivotal to get rid of the state marketing board and the heavy implicit tax it imposed on producers.

In all the countries that achieved reasonably rapid growth, substantial domestic investment was important, and in **Brazil, Egypt,** and **Peru** it was dominant. Both foreign and domestic investment responded to the same incentives: basic security of person and property; macroeconomic policies that made reasonable profits likely; infrastructure that could deliver services with some assurance and at a competitive price; and micro policies that did not adversely affect the industry concerned. Where the environment was less favorable or more uncertain, the likelihood of extraordinary profits could compensate for the higher risk or cost associated with the environment, and investment might still be attracted. That was the case in **Indonesia** during the initial reform spurt of 1966 to 1968, when the survival of even the government was not assured.

17. Sustained poverty reduction may depend on structural reforms aimed at reducing the dependence of the economy on unstable and sometimes declining sources of foreign exchange. Simultaneously, domestic policy needs to channel whatever income the country derives from these sources toward investments in productive assets. Globalization can accentuate the problems of trade instability and foreign-exchange volatility. This result is not inevitable, because more trade often means more diversified trade, which lessens instability. Nevertheless, the problem still plagues a number of countries. **Egypt** is such a case. Its main sources of foreign exchange are oil, remittances from migrants abroad, aid, Suez Canal revenues, and tourism. Dependence on these sources of income leaves the country extremely vulnerable to unpredictable and volatile global forces. Each by itself is unstable; further, some are closely correlated with others, increasing the overall instability of revenues. Oil prices are notoriously volatile and, in addition to their direct effect on Egyptian foreign-exchange income, they have an impact on Suez Canal revenue and tourism, and an even larger impact on the jobs available in the Persian Gulf, which in turn affects both the supply of labor competing for jobs in Egypt and the magnitude of remittances. Employment in the Gulf is also vulnerable to political vagaries, as is aid. Too frequently, the proceeds from these exports have been used to finance consumption rather than investments in productive assets. Remittances have been particularly important for employment creation and income generation, so the fact that they are more volatile than other sources of employment and income is of special concern.

Such volatility puts the sustainability of growth, job creation, and, ultimately, poverty reduction in some jeopardy. One appropriate use of windfall gains from volatile sources is to develop exports that are less volatile, or at least less correlated in their cycles with the current sources. In Egypt, unfortunately, nonoil exports in constant dollars in 1999 were virtually identical with those in 1980, and there had been little growth of revenues outside of the sources mentioned.

18. Making structural adjustment as pro-poor as possible requires carefully designed and coordinated policies to deal with the money supply, the exchange rate, and the major market distortions of the specific economy. Structural adjustment is necessary in an economy where the combination of past trade, macroeconomic, and exchange-rate policies, together with exogenous events such as changes in the country's terms of trade, creates a serious balance-of-payments problem that must be rectified. Such adjustment often necessitates a decrease in total absorption (consumption plus investment). Often, restrictive monetary and fiscal policy used to bring inflation down creates a recession and produces or at least coincides with income and wage declines. The majority of developing countries (and of the case-study countries included in this project) have undergone structural adjustments at some point over the past few decades. Either in fact or in perception (or both), such adjustments often have failed to get the country onto a healthy and sustainable growth path. Among the factors that help determine success or failure in this regard are such obvious ones as quality of macroeconomic, exchange-rate, and trade policy, but also less obvious ones, such as economic structure, recent history, and—very important—whether the structural adjustment program has been designed to account for the country's idiosyncrasies.

It is an important and difficult challenge to policymakers to avoid serious increases in poverty during structural adjustment. This was achieved in **Egypt** and **Uganda** during their structural adjustment programs of the 1990s. **Indonesia's** structural adjustment of the 1960s actually succeeded in carrying out an expansionary adjustment program, with rising consumption and investment and declining poverty. **Zambia** illustrates a less successful experience. A related but somewhat different and broader challenge arises in countries undergoing the transition from centrally planned or state-led development to a more market-oriented system; **Ukraine** clearly failed to meet that challenge.

Uganda succeeded impressively in reducing absolute poverty while adopting Washington-consensus structural adjustment policies in the wake of a civil war. Starting with GDP per capita far below its previous peak did provide some space for easy growth, with 1986 GDP per capita at just 58 percent of the country's 1971 level, but recovery was not just an automatic bounce-back. Policies clearly mattered greatly. Most basic was the Ugandan government's commitment to the program and to its implementation. This commitment came after several years of debate during which the government struggled with the apparent trade-off between inflation control and the need to devalue the real exchange rate. Continuing overvaluation had placed an extra implicit tax on coffee producers and other exporters, driven activities into parallel markets, and constituted the biggest single source of rents in the economy. Yet allowing the exchange rate to float would increase inflation by increasing prices of imports.

Success came after 1989, when decision-making was centralized in the Presidential Economic Council, which brought together the political leadership and a group of able technocrats. A realistic exchange rate substantially increased incentives for producers of internationally traded goods, removed a burdensome implicit tax, and eliminated a major source of rents/corruption. Asians who had been dispossessed by Idi Amin were invited to return and reclaim their assets. As these policies became credible, private capital held by Ugandans outside the economy began to come back in significant amounts. With macroeconomic stability, the movement from market-based activities into subsistence started to reverse. The official monopsony/monopoly of marketing boards and cooperatives was ended, despite the view among most educated Ugandans that the private traders would use their local monopoly/monopsony power to appropriate any increase in prices, with no benefits to the growers. Instead, margins dropped and prices to growers rose dramatically as the result of devaluation and increased competitiveness, providing strong incentives for expanded production and demand for labor. Poverty declined. Subsequent improvement in transport and in the competitiveness of traders helped peasant farmers to increase their production of food and to diversify into rural nonfarm activities. Lower food prices and more labor demand led to a second, and greater, round of poverty reduction among food-crop producers.

Zambia's 1990s experience with structural adjustment contrasts dramatically with Uganda's. Zambia is a classic Dutch Disease economy with a very heavy reliance on copper, which creates little employment. Copper's dominance of the economy has led to severe distortions. Correcting such distortions no doubt poses a big challenge to economic policy. Since its independence in 1964, when Zambia was among the highest-income Sub-Saharan African countries, Zambia's real GDP per capita has declined by 42 percent, and poverty incidence has increased accordingly, reaching 73 percent in 1998. The 1991 elections ushered in a government committed to deep reforms. It moved quickly with stabilization and with agricultural and financial liberalization, arresting hyperinflation and achieving some diversification of agriculture and some financial deepening and growth of the noncopper sector of 5.5 percent per year from 1995 to 2001. Still, the continuing decline in revenues from copper more than offset the growth of the noncopper sector and was not under the control of policymakers. An additional drag on Zambia's economy, though difficult to measure, has been the HIV/AIDS epidemic. The lack of early payoffs to the reforms contributed to increasing government corruption and waning government commitment, which in turn undermined the reforms. Corruption converted potentially productive and poverty-reducing resources into unproductive rents and aborted some reforms that would have eliminated potential sources of graft.

Another problem in **Zambia's** reforms was weakness in the design and implementation of the structural adjustment program. The standard structural adjustment program of the international financial institutions was probably too simplistic. Trade liberalization illustrates the point. Protection was totally removed during a time when the currency was appreciating as a result of the liberalization of foreign exchange and capital markets and neighboring countries were not complying with the negotiated trade agreements. Noncopper exports were hit when the crux of Zambia's problems was the urgent need to decrease its copper dependence and to diversify the structure of its economy more generally. Although agriculture was rightly seen as the potential driving force in the economy and the means to reduce rural poverty, there was no systematic and comprehensive agricultural strategy in place. The implicit assumption seems to be that freer markets will take care of the economy's needs. The structural adjustment program reflected exaggerated expectations regarding the ability of the private sector to fill the vacuum of the retreating public sector, despite a small and weak private sector as a result of more than two decades of government-dominated policies.

The contrast with **Indonesia** is instructive. There, liberalization was gradual and phased, based on the realistic assumption that it would take the weak indigenous private sector years to respond to changed incentives and that foreign investment needed to be limited for political reasons. Liberalization was carefully phased: the initial structural adjustment focused on freeing and unifying the exchange rate, abolishing import licenses, rehabilitating local rural infrastructure while providing employment through a labor-intensive public works program, and providing incentives for rapid growth in rice peasant agriculture, the one sector in which private entities were totally dominant. A vast system of protection and subsidies was not abolished but partially reshaped to make it more effective and less subject to corruption. Mostly this involved changing to generalized subsidies available to everyone engaged in an activity, reducing the discretion of officials. More rapid reforms and greater reliance on macroeconomic incentives would have been more efficient. The continuation of a plethora of subsidies and government control over more than 30 decades fostered widespread corruption, an increasingly serious problem for Indonesia, but it did contribute to growth and helped protect tradable-good production in agriculture and industry from the negative effects of oil windfalls. **Indonesia's** success also owes a good deal to substantial aid, generally unavailable to countries undergoing structural adjustment more recently (see below).

Over the past decade, **Egypt** has been shifting from a state-led, inward-oriented economic system to an outward-oriented market system in which the private sector plays a more dominant role. Critics of the reforms argued that they would harm the poor, but this was not the case: the recorded incidence of poverty actually decreased, from 19 percent in 1990–1991 to 17 percent in 1999–2000. This moderately successful outcome was largely the result of good luck in the form of income from oil and the employment opportunities in the Persian Gulf states for unskilled Egyptian labor. Aid (20 percent of central government expenditures in the 1990s) and receipts from tourism were also very important. As the substantial growth of the Egyptian economy stems largely from income not affected by policy improvements, the country's experience—in contrast to Zambia's—shows the influence of luck or, more elegantly, exogenous variables. The government used the windfalls to effect policy change gradually, minimizing political opposition. For example, the opposition to privatization was alleviated through incentives for workers to retire or resign and a three-year guarantee against dismissal.

19. Foreign aid can be pivotal in supporting difficult economic reforms. Foreign aid proved highly beneficial in some cases in the case-study countries. Substantial official development assistance for **Uganda**, around 5 percent of GDP in 1992–1993, was critical to the successful implementation of the country's structural adjustment program during the 1990s. This aid allowed Uganda to step up investment while increasing private consumption to reduce poverty. The conditionality associated with aid also led to reforms that benefited the poor.

In **Indonesia**, as in Uganda, aid was crucial to expansionary stabilization in 1966–1967. Food aid paid for a program of labor-intensive public works that rehabilitated the country's infrastructure. It immediately created jobs and income for those employed and continued to contribute to growth as the additional irrigation and drainage works and local roads and bridges made for greater agricultural output. The additional food, cotton, and yarn provided by aid also helped bring down inflation. Funding for additional inputs for industry created jobs and income in activated manufacturing that put previously idle capacity to work. Project aid had a slower impact but helped fund larger public works. Finally, aid supported reform. It was access to aid resources that gave an able group of technocrats influence in the early days. The political success of the stabilization effort was in part the result of the substantial foreign resources that became available in support of the reforms. They immediately produced substantial benefits. This success stands in stark contrast to later stabilization programs, without massive aid support, which were contractionary, inflicted substantial short-term gain, and often cost the life of the reform government.

LABOR AND EMPLOYMENT POLICIES

The generation of remunerative employment is key in achieving pro-poor growth. The most important labor market policy to ensure creation of jobs on a large scale is to avoid overpricing of labor, which discourages employment. Other labor policy issues tend to be even more controversial. The country studies shed light on several of them.

20. In most cases, increasing the minimum wage over that prevailing in the market will actually hurt the overwhelming majority of the poor, with only a minority benefiting. Under special circumstances, such an increase may benefit most of the poor. Raising the minimum wage above the wage in the market usually does not benefit the poor as a whole. First of all, most of the poor are in agriculture, small and household firms, or other informal-sector enterprises where the minimum wage does not apply or cannot be enforced. Second, even in formal-sector firms subject to the minimum wage, employers will be under pressure to move factories and jobs to low-wage countries; substitute machinery for labor or circumvent the rules by subcontracting to firms not bound by the minimum wage; hire temporary workers, if they are exempt; or fiddle with the books. The net result is that a tiny labor elite will be helped—those in industries where wages for unskilled workers are not a major cost, profitability is not a major consideration, or facilities cannot readily be moved—at the cost of a great majority of workers who will find fewer jobs created in the manufacturing sector and whose wages will be depressed by greater competition for jobs in activities not affected by the minimum wage.

It is possible for an increase in the minimum wage to benefit a larger group of workers and to reduce poverty when wages of large groups are below equilibrium as a result of a wage–price lag, monopoly/monopsony power on the part of employers, and/or an inelastic demand for some categories of workers. **Brazil's** experience provides possible evidence. There, when the real value of the minimum wage was increased sharply after inflation was brought under control in 1994, a big reduction in poverty followed almost immediately. It is not possible to say to what degree this sequence of events resulted from a link between the minimum wage and wages in the informal sector and therefore was due to the beneficial effect of the minimum wage. The poverty reduction could also be due to the fact that the benefits of many safety net programs in Brazil are tied to the minimum wage, so that the impact on the poor came from greater government transfers to them. The drop in poverty could also have stemmed from the deceleration of inflation or other factors unrelated to the increase in the minimum wage.

The minimum wage can be a policy instrument in poverty reduction only if the increase in the real minimum wage is sustainable; it cannot simply lead to greater inflation through an increase in other wages and prices. Further, the minimum wage must be at a level where it does not push a significant number of workers out of the formal sector. Both of these conditions appear to have been met in Brazil in 1994–1995. They are rarely met elsewhere.

Indonesia is more typical. After 2000, the minimum wage was steeply increased, mostly by political factors. As a result, the actual average wage in medium-sized and large firms in manufacturing reached 50 percent above where it had been in 1996, whereas the wage for agricultural and other informal-sector workers was 15 percent to 20 percent below where it had been in 1996. Less than 5 percent of the labor force is employed in medium-sized and large firms in manufacturing, however, and the number who benefit by the minimum wage in other sectors is even less. Moreover, most of these workers are not among the poor because the industrial wage was already substantially above that for other workers in 1996. It would be a generous estimate to say that 5 percent to 10 percent of the poor saw some increase in pay as a result of the sharp increase in the minimum wage. Finally, even for this small group the benefits seem to be mostly short-lived. Footloose industries have already started to move out. A combination of an appreciating exchange rate and rapidly rising wages for firms in the labor-intensive export industries is proving deadly, especially in competition with China, Vietnam, and other countries that are keeping nominal wages under tight control. The net result is that a tiny labor elite will be helped, in industries, as noted above, where wages for unskilled workers are not a major cost, profitability is not a major consideration, or facilities cannot readily be moved—at the cost of a great majority of workers who will find fewer jobs created in the formal sector and whose wages will be depressed by greater competition for jobs in activities not affected by minimum-wage legislation.

21. Two sectors have created most of the additional demand for labor crucial for poverty reduction: agriculture and, to a lesser extent, parts of manufacturing. Their growth has been pro-poor. Growth of sectors where the poor are disproportionately located is not necessarily pro-poor. Agriculture is labor-intensive in most (but not all) countries. So are industries competitive in countries with labor that is low-cost. In the early stages of development, agriculture is typically a leading sector, producing food to meet increasing domestic demand and to sell to parts of the world market that are reasonably competitive. It therefore creates a large proportion of additional labor demand. Later domestic demand for food grows relatively more slowly. Some countries are highly competitive in a large world market (for example, Peru for flowers, Thailand for rice, Brazil for oranges and beef, and Ghana for cocoa), but many run up against protectionist policies or limits of the world market. Industry then tends to become the leading sector. Quite soon the domestic market for labor-intensive manufactures is satisfied and manufactured exports become the leading sector generating demand for unskilled labor and therefore key for poverty alleviation.

For **Uganda,** poverty reduction under the new government was initially based on the expansion of labor-intensive coffee exports. With incomes up there was greater demand for food and scope for import substitution in food. In the second phase, poverty reduction was based on growth in food production for the domestic market. In **Zambia,** the inability to expand production of labor-intensive agricultural exports left it unable to create the labor demand needed when copper income faltered. This was aggravated by the decimation of the small labor-intensive industrial sector by the premature withdrawal of protection, with disastrous consequences for the poor.

For both **Indonesia** and **Sri Lanka,** the agriculture sector provided significant employment and much of the increase in employment in the first two to three decades after independence. The size of the harvest then mattered to employment in the short term and to the growth of agriculture in the long term. Rapid growth after reform was still very much agriculture-based, as both countries invested heavily in the agricultural infrastructure and adopted the new fertilizer-seed-irrigation technology. Because that technology was labor-intensive, agriculture also remained important to demand for unskilled labor. By the 1980s, however, the role of agriculture in the economy had declined. The labor-intensive technology had run its course and some laborsaving methods had begun to be introduced. There was and remains potential for expanding labor-intensive production of specialty crops (tropical fruits, palm oil, cocoa, and shrimp in Indonesia) and for expanding the production of goods increasingly important in the domestic diet (vegetables). The leading sector for job creation since the 1980s, however, has been manufacture exports. Because agriculture remains the largest employer of unskilled labor, it cannot be neglected in a pro-poor strategy, but it is no longer the key to it.

In **Peru, Brazil,** and **Egypt,** agriculture has played a smaller role in job creation for a longer time than in the Asian countries, but agriculture is important in all three. Many jobs have been created in **Brazil** and **Egypt** by the opening of new lands, the expansion of irrigation, and similar measures. In all three countries, important parts of agriculture are successful exporters and respond to the same changes in incentives that affect manufactured exports, above all the exchange rate. Nonetheless, the leading factor determining what happens to the poor is the ability to export labor-intensive goods, especially manufactures.

In **all countries studied,** large parts of construction—especially of residences—is labor-intensive. Because a strategy that makes construction, or other nontradables, the leading sector soon encounters balance-of-payments constraints, such industries have not played the role of leading sectors.

The World Bank team that reviewed poverty in **Peru** for 1994–1997 reasoned that the structure of growth was pro-poor because it was driven by the sectors in which poverty was highest. This conclusion does not follow logically, however. Growth should be concentrated in the sectors that can best (most efficiently) create it. The long-run process of development involves a gradual shift of labor out of agriculture and into other sectors. If poverty is exceptionally high among workers in the agricultural labor force, this will often reflect a lack of good income-growth options in that sector, in which case it is likely to be more helpful to have these workers move into the manufacturing sector, where poverty may be low. Nonetheless, it is more often true that the potential of agriculture to create jobs is neglected by policymakers because of urban bias.

22. Although greater flexibility of labor markets should raise efficiency, neither the extent of benefits nor the range of conditions under which gains would be large is clear. Some reforms to increase flexibility thus should be viewed cautiously. Although international financial institutions have pressured **Egypt** to increase the flexibility of its notoriously rigid labor market, it took eight years for a new law increasing flexibility to be passed. This is in part because flexibility is not a high priority for most domestic businesses. Although de jure labor legislation in Egypt has been rigid, in reality domestic firms have developed mechanisms to largely avoid compliance. Labor legislation has posed more of a problem for foreign firms because they are an easier target for inspectors. With more flexible labor legislation, Egypt should become a more attractive destination for foreign direct investment. The de facto flexibility, mainly enjoyed by domestic firms, means, however, that labor market reform may not be as central as is often assumed.

Peru's labor restrictions also were not one of its fundamental problems. Although the Peruvian reform was extreme, which should in principle make it easier for analysts to sort out its effects, the government simultaneously raised labor taxes, thus aggravating one distortion associated with labor legislation. One of the more general reasons the impact of labor reforms is hard to predict is that loosening restrictions may discourage investment in human capital.

23. Policies that make capital available at below its social opportunity cost are anti-poor. Exchange-rate overvaluation makes imported machinery available at below its true economic or opportunity cost. Although none of the country studies looked at this issue in detail, it was probably one mechanism that produced the weak employment elasticity of growth in **Peru** during the 1990s. Administrative rationing of capital in **Ukraine** made it too cheap for large state or formerly state enterprises and too expensive for everyone else. Large capital-intensive firms were able to get low interest rates and often did not have to repay, encouraging those firms to choose machines instead of workers. The effective subsidy on capital also improved large firms' competitive position vis-à-vis smaller, more labor-intensive firms. Again the result was that cheap capital reduced labor intensity.

In **Indonesia,** as well, larger and generally more capital-intensive firms had easier access to cheap credit. This exemplifies a common pattern, as does the resulting highly dualistic structure of firms. It clearly fosters greater capital intensity and reduces the number of jobs created. In 1984, the government-sponsored Indonesian Peoples' Bank (Bank Rakyat Indonesia, or BRI) expanded its program for microcredit and credit to small and medium-sized enterprises, which began the process of redressing the balance.

Sectoral Growth Policies and Programs

Education and Health

24. In poor countries, the expansion of social-sector programs often benefits the poor disproportionately. Although most social-sector programs in low-income countries are not designed to benefit primarily the poor, their expansion often does. The nonpoor already have reasonably good access to these services. If need be, they can send their children to schools that require fees or to public schools that require private transport to reach them; they patronize private doctors anyway; and they purchase their housing in the market. When government extends primary and secondary education to new areas or cities or the countryside, most beneficiaries are usually poor. Better, or more accessible, public health-care facilities will also be used mostly by the poor.

From 1950 to 1977, **Sri Lanka's** system of free social services, superb compared with that of other countries at similar per capita incomes, was of special benefit to the poor. It saved them from having to spend scarce income to provide education to their children or obtain medical services. It also ensured that their children entered the labor market better able to compete with the children of the nonpoor and to escape the culture of poverty. This contributed to the greater equality fostered by the Sri Lankan welfare state. The egalitarian nature of the system was eroded with the reforms of 1977. The rising pressure of the fiscal deficit and the policy change to a more market-oriented system resulted in a declining share of GDP going to social services. The private sector came to play a larger role.

During the more welfare-oriented strategy, more than 6 percent of Sri Lankan GDP was devoted to social-sector expenditures; afterward, during the more growth- and market-oriented strategy, this fell significantly, to about 4.5 percent. The impact on the poor of that one-quarter decline cannot be determined without additional work, but it is a factor in explaining why more rapid growth after the reforms did not benefit the poor proportionately.

25. Low-quality public education restricts the flexibility and learning capacity of the labor force, holding down competitive strength especially in nontraditional fields. **Peru's** history in the provision of social services provides a stark contrast with that of Sri Lanka. The Peruvian economy's growth has been impeded by an inability to rapidly expand output and exports in nontraditional fields. Wages are not low enough to compete with low-wage Asian countries, so the challenge is to move into products requiring more than basic skills. The ideal remedy for the long run is to increase competitive strength progressively by investing in human resources and to improve capacities for learning and for taking initiative in new fields.

Agriculture

Increases in agricultural production tend to benefit the poor more than growth in other sectors, because agriculture is labor-intensive in most countries (Argentina and Uruguay are the principal exceptions among poor and middle-income countries). Agriculture creates more demand for labor per unit of output than most sectors, which are more capital-intensive. By producing food and sometimes other goods important in the expenditures of the poor, agriculture can lower costs for the poor disproportionately. However, there has been an anti-agriculture policy bias in some countries historically as they have identified development with industrialization, at some cost to poverty reduction efforts. In some Latin American countries, it now appears that output expansion (as distinct from existing production) is no longer labor-intensive, in part due to the character of landownership and biases in public policy.

26. Pro-poor effects in the agriculture sector can be achieved through the removal of excessive regulations and taxation (direct and indirect), both of which have impeded agricultural development in many developing countries. Reform/liberalization of **Egypt's** rice sector resulted in increased production, significant employment generation, higher prices for farmers, lower prices for consumers, and increased exports. Before the reform program began, all stages in the rice sector, from farmers to consumers, were controlled by the government. Farmers were told how much rice to grow, and they were mandated to deliver a certain portion of their harvest to government warehouses at government-controlled prices. The government banned private marketing of rice, and only public-sector mills or a few specially licensed private mills could legally mill rice. The right to export was granted to a few public-sector mills, cooperative societies, and public-sector marketing companies.

The Egyptian government eliminated most restrictions on the rice sector in 1991. The response was immediate and huge. The average size of a rice farm is approximately one *feddan* (about one acre), and more than half of rural households are involved in rice production. Consequently, the sector's liberalization significantly affected poverty reduction in rural Egypt, even though rice is a minor crop in most areas.

Uganda's dramatic economic recovery from 1992 to 2000 (when per capita real GDP grew at almost 8 percent per year) was concentrated in the agricultural sector and greatly facilitated by the elimination of the state marketing board system. Although there was an element of good luck—with a temporary surge in world coffee prices as a result of frost in **Brazil**—growth has been sustained even when coffee prices have fallen drastically again. A higher share of world prices now passes to the peasant producer, contributing to a rise in marketed output. Private investment, also, has increased.

In **Indonesia,** ending compulsory monopoly procurement of cloves and other cash crops resulted in a substantially increased share of final prices going to the producer. In turn, that led to greater output and increased demand for labor. The provinces that are major producers show real wages rising at a far higher rate than in other provinces. The policy change generated a direct cash transfer from those who held the monopoly/monopsony rights to farmers and farm workers.

27. Output of agriculture can increase quite rapidly if appropriate technology is available and its introduction is speeded by judicious use of price policy and infrastructure development.

- **Indonesia** moved from a highly controlled system to one using market incentives and government support, rather than controls, to increase output. Minimum prices for the most important crop, rice, were ensured to reduce the risk of farmers in paying for modern inputs required by the new technology. Fertilizer was subsidized, but not rationed, to speed its introduction as part of the new high-yielding fertilizer-seed-irrigation technology. Its subsidized price was fixed in relation to the minimum guaranteed price of rice, to ensure that using it would profit farmers. By making the subsidized fertilizer available in the market and not allocating it to a limited number of buyers, the system ensured that it did not become an informally rationed good, made available on a patronage basis. Meanwhile, seed development was paid for by the government. Irrigation systems were rehabilitated or constructed under the government's labor-intensive public works program, as were rural roads to facilitate the distribution of inputs and the sale of agricultural products. Food crop production as a result grew at 5.5 percent for a decade, a high rate for smallholder agriculture, and made the most important contribution to keeping rice prices low and creating demand for labor.

- **Sri Lanka** achieved an even higher, 7-percent growth in rice agriculture during roughly the same period, exploiting the same technology package. Market incentives were emphasized during only part of this period. Government support for infrastructure development, reduction of risk, and technology change played similar roles as in Indonesia.

Finance

28. Well-designed, commercially organized provision of microfinance can play a large role in meeting the credit needs of small borrowers in low-income countries on a sustained basis, provided that ill-conceived government regulations do not prevent them from doing so.

The **Indonesian** experience in providing credit to small borrowers was unusually successful. The setting was not notably more propitious than in many other countries; neither private nor public banks were interested in lending to new enterprises or small ones that wanted to expand. Traditional government credit programs of the 1960s and early 1970s, some designed to offset the bias against small borrowers, were typically inefficient and of little help to the poor, except as occasional handouts. With subsidized interest rates and low repayment rates, they quickly became patronage programs, primarily for the nonpoor large and more influential farmers. Because they were costly to maintain, they could not be expanded rapidly and were not self-sustaining.

In 1984, the Indonesian Peoples' Bank, BRI, faced with mounting losses in its already existing microcredit unit, launched a serious commercial effort in microfinance. Like other finance institutions, it had operated under a government-imposed interest rate ceiling. The interest rate was highly subsidized and loans became a perk for village elites with poor repayment records. The deposit rate was above the lending rate, making expansion of the credit program difficult. The 1983 reforms permitted all government banks to set their own interest rates. Thus, in 1984 BRI launched a new program of general-purpose loans with a real (above inflation) interest rate of about 20 percent, set sufficiently high to cover all costs. Equally important was a program to provide facilities for savings and time deposits to rural areas and eventually urban small depositors.

The key to the success of these programs was their operation on a commercial basis. Each rural unit was seen as a profit center, and its success was measured primarily by the usual criteria of private banks. Outstanding small loans by BRI rose so that by 1995 they were the equivalent of $1.4 billion, or nearly equal to 1 percent of the national income. Small rural savings deposits increased even more dramatically; all savings accounts at BRI alone, most of them rural, amounted to an astonishing 3 percent of national income. Repayment rates on loans were consistently 98 percent or better, and the system was not only self-supporting but profitable and generated substantial annual savings for the economy.

Despite its being perhaps the largest successful microcredit program in the world, it is difficult to discern from BRI any impact on poverty. Borrowers gained compared with nonborrowers, but it is not clear that the greatly expanded microcredit program created a significant number of jobs.

29. Loans to small borrowers can be less risky than loans to large borrowers. Another remarkable development in **Indonesia** occurred after the Asian Monetary Crisis: the rapid expansion, albeit on a small basis, of bank willingness to lend to small and medium-sized enterprises (SMEs). Both private- and public-sector banks discovered that repayment rates varied inversely with loan size. The experience of BRI is typical. Corporate loans, many for hotels or offices, experienced large-scale default and were transferred to the government agency that handled loans to bankrupt and other enterprises that could not services their loans. Although most corporate loans at BRI and other banks were in default, less than half of SME borrowers missed even one interest payment. Banks had discovered that small borrowers overwhelmingly resumed servicing their loans as soon as they could, whereas some corporate borrowers simply defaulted; others paid only a fraction of the principal, or they turned over assets to the government's bank reconstruction agency that were worth only a fraction of their claimed value. The microborrowers had the best repayment record of all, but lending to them was administratively too costly for most banks. As a result, BRI's well-run program for small loans was expanded. More important, it was supplemented by increasing lending to small borrowers by commercial and government banks other than BRI. As yet, no study seems to exist on the impact of these programs on job creation, but Indonesia demonstrates the feasibility of a massive expansion of small and micro credit to support the most labor-intensive firms in the economy, especially in rural areas.

By contrast, **Sri Lanka's** government-owned commercial banks continued to provide loans at below market rates to favored borrowers. If they operated at a loss, it was difficult to determine whether that was due to their supposed social objectives of providing cheap credit or their inefficiency, including high labor costs for well-organized and politically powerful bank employees. They did not play an increasing and dynamic role in economic growth or poverty reduction.

TARGETED PROGRAMS

Social safety net (SSN) interventions are an essential part of the poverty reduction arsenal. Effective targeted programs help retain support for economic reforms by supporting those most affected by shocks and economic setbacks. Safety net programs can target individual households, communities, or entire regions, but the challenge is to ensure effective targeting. Many supposedly targeted programs actually benefit the nonpoor as much as or even more than the poor. The experiences of the eight countries studied here present useful lessons on what works.

Labor-Intensive Public Works Programs

30. Labor-intensive public works programs have several advantages over other targeted or SSN programs in achieving two objectives: providing employment and income in the short term and adding to useful infrastructure in the long term. From the 1970s, **Indonesia's** labor-intensive public works programs provided temporary employment and income to the poor in the agricultural off-season, during periods of drought or flood, or when other sources of income were inadequate for whatever reason. They generated double benefits to the poor: jobs and income plus infrastructure (local roads, irrigation and drainage works, primary schools and health-care centers, bus stops, and markets) that contributed to additional production, employment, and income over the long term. As a result of near-perfect targeting and with small but meaningful expenditures exceeding 1 percent of GDP, the program had a measurable impact on poverty. It employed nearly 10 percent of the labor force, and it made a major contribution to rural infrastructure and therefore to agricultural output, rural education, and trade.

31. Labor-intensive public works can readily be made self-targeting by paying wages low enough so that only the poor will take the jobs. Near-perfect targeting can be achieved.

In **Indonesia,** low wages were paid for much of the period the program was in existence. As a result, the program was successfully self-targeting. Wages were below those in industry and close to those of agricultural workers.

32. Labor-intensive public works programs can be flexible and well-run if they are locally administered within carefully designed national requirements.

In **Indonesia,** local planning and execution ensured flexibility and made local needs and priorities paramount. Local leadership usually meant there was a direct interest in preventing corruption, waste, and malfeasance. Local management, however, meant there was also the danger that local elites would use the projects to their own benefit. Moreover, local governments might lack the funding and technical competence to carry out an effective program. Both problems were substantially overcome by a national system of funding, technical help, and after-the-fact inspections and audits. (To uncover malfeasance, inspections and audits were carried out by a national agency independent of local executing officials.)

Other Targeted Programs

It is very difficult to achieve high levels of efficiency (little waste and little leakage to the nonpoor) in SSN programs, but some are much better than others in this respect, and some have made important contributions to poverty reduction. The danger of waste in SSN programs is exemplified in the cases of **Egypt, Ukraine,** and **Sri Lanka**. Some of **Brazil's** expenditures, meanwhile, were well-targeted.

33. Subsidies are difficult to target well. Ideally, they should be self-targeting, ensuring that goods and services that only the poor will buy are subsidized.

In **Egypt,** a legacy of earlier populist policies is a sophisticated social protection system. It is highly inefficient, however, as most of its programs have benefited the nonpoor at least as much as the poor. Without self-targeting, serious leakages have been unpreventable. A recent World Bank report[16] estimates that income from transfers (including government transfers, pensions and social security benefits, private transfers, and remittances) has provided 10 percent of the income of the poor compared with 15 percent for the nonpoor. Yet the poor have received only 5 percent of all national transfers—the nonpoor have received almost all of them.

Egypt's food subsidy program is the country's most important social welfare program. Initiated as a temporary measure to assist Egyptians during periods of scarcity, it ballooned into an entitlement program and a large drain on the national budget. In the 1970s, a wide range of items, including lentils, chicken, meat, rice, bread, sugar, tea, and cooking oil, were included in the program. Expenditures grew from LE 3 million ($900,000) in 1970 to LE 1.4 billion ($411 million) 10 years later, or 14 percent of total government expenditure. Since the 1980s, the program has diminished in importance. The basket of subsidized goods was reduced and the entire population received ration cards, red for the more needy or green for the nonpoor. By the late 1980s, the government reduced the number of red cards and further changed the basket of goods. In the mid-1990s, it stopped granting ration cards to newborns, ensuring an eventual end to the program.

Baladi bread, in contrast, is subsidized for all consumers. The legendary bread riots in the 1970s have made it nearly impossible even to mention eliminating this subsidy. Partial self-targeting was introduced by reducing the quality of the loaf, making it less attractive to the nonpoor. A large number of poor thus benefit from subsidized bread. Given the shallowness of Egyptian poverty, this program lifts large numbers out of poverty. According to the World Bank, without the baladi-bread subsidy, "730,000 more people would have been in poverty."

Sri Lanka's extensive subsidy net system demonstrated that it is possible to transfer enough income from richer to poorer to significantly improve the income and consumption of the poor. Sri Lanka's subsidies for food (mostly rice) and other transfers exceeded 6 percent of GDP in some years and at a minimum were 1 percent of GDP. Sixty percent of rice subsidies reached the poorest 40 percent, raising their income by up to a quarter. For the poorest 20 percent, the impact was more massive. Large transfers were initially easier because they could be funded by taxing concentrated incomes in the plantation sector, going mainly to nonvoting foreign owners, managers, and workers. But it was a strongly egalitarian ethos that was crucial to political support from both major parties for a massive welfare system. The

[16] The World Bank (2002). *Poverty Reduction in Egypt: Diagnosis and Strategy,* Volumes 1 and 2, Washington, D.C.: The World Bank.

subsidy programs, however, were only moderately efficient, because they were not well-targeted. In 1978, the provision of more food stamps in poorer districts and community selection of recipients achieved modest progress, but the program had elements of patronage and increasingly was subject to political influence and ethnic bias. The targeted programs also were not easily adaptable to SSN needs, and they did not develop infrastructure.

Targeting could be substantially improved, which would increase the benefits to the poor by about one-third, by ending or revamping the fertilizer and credit subsidy programs that are now regressive; making greater use of geographic targeting and restoration of local determination of eligibility; making food subsidies self-targeting; or starting a self-targeting, labor-intensive public works program. Such a package could also serve as a social safety net and would generate additional infrastructure investment. However, it would require a strong political backing to change from an entitlement program, requiring little from its beneficiaries, to a program where payment has a real work requirement.

34. The effectiveness of targeted programs depends largely on the efficiency of targeting.

Ukraine has an extensive and complex safety net system. It has been modestly successful in alleviating poverty, but its system is seriously inefficient in targeting and program delivery. Many of the remaining entitlement programs are unsuited to the new setting toward which Ukraine is evolving, whatever their logic in the pretransition period. The intricate and sometimes overlapping system of social privileges and family allowances consists of various cash benefits and subsidies. Some programs are specifically targeted, but many define eligibility by particular social and occupational groups such as veterans, police officers, judges, and customs officials. Social privileges subsidize housing and housing maintenance, public transport, utilities, drugs and medical services, and credit, among other items. There are 11 types of family allowances, including a lump-sum birth grant available to all. A major institutional reform is required to streamline the system, which is currently based on a multitude of laws, codes, decrees, and resolutions issued by the president, the parliament, the cabinet of ministers, and local authorities. Effective targeting is the key challenge.

A major factor in **Brazil's** impressive poverty reduction in the 1990s was a set of targeted programs. The most important of these is a noncontributory rural pension scheme. It spends about 1.2 percent of GDP. Pensions for the aged and disabled, linked to the minimum wage, cost roughly another 1 percent of GDP. Although no one has estimated the impact of these programs on poverty, the fact that poverty declined substantially in the 1990s, when these programs were started or expanding, is strong evidence of their effectiveness. It was a remarkable achievement, as the '90s were a period of hyperinflation and falling per capita income, two factors usually devastating to the poor.

The reason for the pension programs' effectiveness was their good targeting: the largest program was limited to people who had worked in agriculture for at least 10 years and were not covered by formal-sector pensions; the others went to the aged or disabled. These are all categories that are relatively easy to establish and that are relatively small.

Compared with many countries, Brazil also has a relatively good civil service and an effective political process. As already noted, Brazil also spent another 17.5 percent of GDP on social expenditures, mostly pensions for formal-sector employees, which were not targeted. They were actually anti-poor, because their cost slowed growth, and slow growth harms the poor, and their benefits went overwhelmingly to the nonpoor.

CROSS-CUTTING ISSUES

Post-Conflict Policymaking

35. A combination of quick defusing of security threats, gradual reestablishment of trust, astute macroeconomic policy, and selective removal of key distortions and impediments to growth can produce rapid and sustained growth in the wake of civil war.

Uganda was a basket case in 1986, when the National Resistance Movement under Yoweri Museveni came to power through a successful guerrilla war. The country had suffered from more than 15 years of misrule, violence, and pillaging of economic resources by Idi Amin, Milton Obote, and short-lived military regimes. Real GDP had declined by more than 40 percent, and much of the population had retreated from formal-sector economic activity into subsistence production. The government lost the ability to mobilize resources through an orderly fiscal system, foreign exchange was unavailable, and high levels of inflation were the result of uncontrolled expansion of the money supply through deficit finance. The influential Asian commercial group had been expelled in 1972, resulting in capital flight and a collapse of the country's established trading systems.

The Museveni government has turned the Ugandan economy around impressively. The first order of business was to restore order and maintain security. The government quickly established the preconditions for reconstruction, promoting an attitude of reconciliation and refraining from using its victory for retaliation. Soldiers were relatively well-disciplined, and the courts were not used to oppress opponents; instead, the government tried to draw the opposition into government. Soldiers from the pre-existing Ugandan army were integrated into the new force, and demobilization was delayed until late 1992 because of fear of actions by demobilized soldiers. In any case, the basic task of restoring security was accomplished well. Then, reconstruction, particularly of devastated coffee-producing areas, was undertaken. Economic growth resumed, inflation rates declined to moderate levels, private investment expanded, and coffee exports recovered.

Governance

36. Governance matters to the poor because it affects the rate of growth and can affect the rate of inflation, both of which influence poverty. Governance also affects the ability to target programs designed specifically to help the poor, as the poor are especially vulnerable to corrupt officials. Ending corruption is a widespread political demand of the poor, as is greater control over their lives. The incompetence and venality of a series of governments in **Uganda** were major factors in the collapse of the country's economy. The restoration of competence and a measure of honesty, in turn, was key to the turnaround in Uganda's economic functioning, which greatly benefited the poor.

Corruption in **Indonesia** is a major factor mentioned by investors in explaining why, more than five years after the Asian Monetary Crisis of 1997–1998, private funds are still flowing out of the country when inflows would enable the economy to grow at a rate sufficient to raise wages rapidly again in agriculture and the rest of the informal sector. The end of "Corruption, Collusion and Nepotism" was a central demand in the riots of 1974, the overthrow of the Soeharto government in 1998, and the electoral defeat of the Habibie government subsequently. The poor participated actively in these events. They are directly affected by the petty corruption that proliferates when corruption is widespread throughout the government.

37. Appropriate economic policies are crucial to growth, which reduces poverty. Such policies cannot be adopted and implemented without political support, as actions that distort the economy are almost always undertaken for a political reason—they benefit some powerful group. Pro-poor policies therefore need to be framed to lessen their political costs and maximize their political benefits.

In **Egypt, Sri Lanka, Uganda,** and **Indonesia,** policies that distorted the economy, created inefficiencies, slowed growth, and generated huge rents or corrupt incomes were maintained not just for years but for more than a decade. Their costs to the economy were evident and frequently pointed out, but such policies as a complex import licensing system, government-directed or allocated credit, export licenses, and government ownership of inefficiently run commercial enterprises persisted because they generated large incomes for the favored few who received licenses, credit, and government-produced goods as well as windfall gains to the officials who controlled these perks. Change in all four countries usually required a change in government. It also required that the new government be persuaded that a fundamental change in policies could bring substantial economic benefits that could be translated into political rewards that would exceed the political costs.

It is easier for the political leadership to execute specific reforms if the political benefit–cost ratio is favorable. **Egypt** and **Sri Lanka** were more successful than **Indonesia** in privatization, for instance, because they adopted better measures to compensate several major potential losers from the process. **Indonesia,** however, was able to carry out its drastic reforms of 1966–1968 because donors supported the reforms in a way that avoided the usual large costs of a structural adjustment program: they funded imports and public works programs, which made this an expansionary stabilization program instead of the usual contractionary stabilization program.

38. A small group of highly qualified technocrats, in a symbiotic relationship with the political leadership, can make a crucial contribution to good economic policy. Political leaders very rarely are competent in economic policy formulation. They can obtain competent advice from international or bilateral donor agencies, but using these sources bears costs and disadvantages. The outside advisors may not, for example, be thoroughly familiar with the country or attuned to its political reality. Additionally, use of foreigners in key positions creates a political liability, and the country's leadership must always be leery of the possibility that the advisors will be loyal to the donor agency rather than to the recipient country. A small cadre of high-quality citizen–technocrats can, however, play an enormously useful role if they can gain the confidence of the leadership. This is illustrated clearly in the cases of Uganda and Indonesia.

In **Uganda,** the successful reform program of the 1990s was based on a strategy for macroeconomic policy adopted and implemented by a technocrat group within the Ministry of Finance, Planning, and Economic Development. These officials received much higher pay than did ordinary members of the civil service, their employment was based on explicit implementation of performance criteria, and they came to wield considerable influence with the president. They had no independent political base but were supported by the president based on the success of the measures they recommended. In turn, they had direct access to donors and were essential to the country's ability to attract much-needed resources.

In **Indonesia,** a group of highly trained economists was especially important in maintaining effective macroeconomic policy (for example, regarding exchange-rate policy) and significant in other policy areas, as well. This goes a long way toward explaining that country's atypical success in achieving high rates of pro-poor growth. The economists' longevity and great influence were due largely to their success in producing growth at low political cost. Growth in turn provided resources that could be used to keep key political constituencies happy. The original inclination of the new leadership drawn from the military had been to use orders and controls rather than economic incentives. The technocrats had to overcome that inclination and gain the confidence of their ex-military bosses. This they did by producing quick results—a key requirement for good economic advisors. The technocrats strengthened their team by drawing on foreign economists, demonstrating that foreign technicians can be most effective if their advice does not go directly to the political leadership but is filtered through and mediated by their domestic advisors.

39. An important prerequisite for improving governance is to reduce the burden on the government. That requires, above all, reducing the use of policies and programs that have to be implemented against the self-interest of the implementers and maximizing the use of policies that enlist the self-interest of those who carry them out.

All eight case-study countries followed this principle at times and violated it at others. When **Brazil, Peru, Uganda, or Indonesia** made it highly profitable to export, by providing a favorable exchange rate, potential exporters found it in their interest to export. Their self-interest and the society's interest were aligned. When the same countries operated with an overvalued exchange rate, the potential exporters' self-interest was to minimize their exports. Government would then try to get them to behave in society's interest by offering subsidized loans, for instance. However, the self-interest of those who granted the loans lay in receiving as big a bribe as possible for as small a loan as possible, while those who received the loans wanted to get the biggest possible loans for the smallest possible amount of exports. Their interests were not aligned with society's. The result was a small increase in exports, corruption, and inefficiency; in other words, bad governance. Reforms that incorporated appropriate exchange rates and abolished import and export licenses eliminated, in one fell swoop, a huge area of bad management and corruption.

40. Major institutional and administrative improvements are at least occasionally possible in low-income countries.

In **Peru,** where the level of taxation has historically been too low to provide sufficient financing for needed social investment, a major institutional innovation took place in the early 1990s with a new tax agency that proved able to raise the efficiency of tax collection and hence the share of GDP available for public spending. This experience shows how much a low-income country can advance in this domain without a tradition of strong administrative capacity in the public sector. Unfortunately, the experience also demonstrates the fragility of such gains: toward the latter part of the 1990s, Peru's tax agency was subjected to serious political intervention and manipulation and lost much of the efficiency gains it had made. Protection from such intervention is clearly needed to hold on to such efficiency gains, but this experience at least demonstrates that the gains can be made.

41. Dealing effectively with opponents of reform may be necessary for successful implementation of certain types of reform.

Egypt's experience under its structural adjustment program in the 1990s demonstrates the importance of recognizing and dealing with issues of political economy that inevitably arise in the process of reform. Because the government was highly cognizant of the potential political opposition to privatization and tenancy law reform, it mollified potential opponents. In the case of privatization, it provided financial incentives for workers to retire or resign, provided a three-year guarantee against dismissal, controlled the speed of privatization, and overall helped jumpstart the previously stalled process. In the case of tenancy reform, the government provided reclaimed land to affected farmers and undertook actions that greatly contributed to the success of the reform.

42. Governance problems in transition economies can be magnified by the severe lack of consensus on economic direction and policy, the great distance to be covered before becoming a well-functioning market economy, and the lack of experience in open democratic government. Despite what appeared on the eve of **Ukraine's** independence to be bright prospects for the country's successful transition to a market economy, the process has been very painful, involving a sharp economic collapse, a significant increase in inequality, and a major rise in poverty. This unhappy outcome has been blamed on the combination of a sluggish reform process, negative exogenous shocks, and a high level of corruption. An intractable political setting in which there has been strong opposition from powerful groups to the transition has contributed directly and indirectly to the inertia, a lack of coherence, and the corruption.

An underlying cause of weak and ambiguous decision-making and of weak implementation of many of the decisions made has been the division of political power among reformers, anti-reform Communists, and rent-seeking opportunists. It is unclear whether a sequencing of reforms could have been designed so as to prevent the extreme levels of corruption that have emerged. Another deterrent to rapid progress in reform is the institutional inertia of the former command economy, which leads to the maintenance of many policies that are counterproductive in the context of a market economy, including a dense network of regulations and an oversized group of bureaucrats in charge of them.

The important objective of moving from a large-scale state and collective farm system (complemented by small household plots) to a system of individual family farms has made only modest progress in Ukraine because of strong opposition from some quarters (the Communist and opportunistic groups) and because, institutionally, the distance is long from the old system to the new. The process runs the risk of creating something closer to a Latin American–style *latifundia-minifundia* system of land concentration than to a more egalitarian family farm system. The closer it comes to the former, the more anti-poor will the agricultural evolution have been.

The complexity involved in a reform process like that in Ukraine has been seriously underestimated by some of the participants, contributing both to some bad policies being adopted and to delays in the implementation of needed ones. The most striking example of oversimplification was that of the Western economists who confused lack of restraints on markets with well-functioning markets; put another way, they failed to recognize that many markets, if they are to work well, do require the constraints of an adequate legal system, of transparency, of minimum levels of competition, and so on. Failure to recognize these needs contributed to the delay in embarking on the institution-building that must accompany such a major transition.

43. Even under the best of circumstances, the transition from a controlled to a market economy is a long and painful process, because it requires building the institutions necessary for a well-functioning market economy. Sequencing and speed of change are crucial to minimize the costs to the poor.

Indonesia is a perfect example of difficult transition. The country's transition began in 1966 and has yet to be completed in 2004, because market economies cannot function well without changes in people and development of institutions. Both of these conditions are slow processes. Indigenous Indonesians had little or no experience with performing various crucial roles in a market economy. A new generation of experienced entrepreneurs has just begun to play a major role, 40 years after the transition began. Bank supervisory institutions are still weak, as is auditing, public accountability, and on and on.

The attempt to move instantly to a market economy is bound to have serious problems, as **Ukraine** shows. On the other hand, to use the difficulty of the process to slow change to a glacial pace, as **Egypt** has done, is equally dangerous. The benefits of reform are often limited unless the reforms are reasonably swift and fundamental. Timing and sequencing are important, albeit difficult.

Gender

44. Features of the growth process can significantly affect earnings differentials between the sexes and hence reduce poverty among women. Regardless of the economic growth rate or the effectiveness of targeted programs, women's compensation is almost universally less than men's. There is therefore an important gender dimension to poverty. Differential compensation is important for all women, and for pro-poor strategies and policies, but it has a particularly severe impact on women-headed households. Some of the countries in our sample lacked data on differential pay or income, but data for **Indonesia** and **Egypt** affirmed or strongly suggested lower pay among women. The single exception, in this case as in others, is **Sri Lanka**; however, very limited evidence from **Indonesia,** essentially the parallel movement of wages for women and men, suggests that poor women can benefit equally with poor men from a high rate of growth. In Indonesia, the income of poor women rose and fell as much as that of men, although remaining well below that of the latter.

45. Rapid growth of traditionally female-dominated occupations is the best way to increase income among women. Rapid growth of traditionally female-dominated occupations, resulting in a rapid increase in the demand for female labor, can eliminate the wage–income gap between women and men. In **Sri Lanka,** poverty among female-headed households has been no greater than among male-headed households because poor women have benefited from the rapid growth of employment in two sectors that are often spurned: garment exports and migration as maids. Both provided employment to poor unskilled women and raised wages for all women in the labor market from the mid-1980s to the mid-1990s. Employees in the garment factories were almost exclusively women, and more than two-thirds of all migrants since 1989 have been women. Of the women migrants, 88 percent to 95 percent have been either housemaids or women falling into other unskilled categories, overwhelmingly drawn from poor families.

The growth in garment exports and maid migration developed as the result of the reforms of 1977. Although there were reports of abuse, for the overwhelming majority of participants, the growth in these two sectors substantially increased incomes. To attract the footloose garment industry despite Sri Lanka's relatively higher wages and advanced labor protection laws, the country created export-processing zones with low taxes, no tariffs, no restrictions on imports, and lower labor costs and regulations. These areas also provided good infrastructure and attractive conditions for foreign investors, especially in export industries. The reforms also facilitated migration to the Persian Gulf states in search of jobs and improved the conditions for returning labor. Sri Lanka was not much better than other countries at protecting its migrant women workers in the recipient states, but it was better than other countries at protecting them from levies and fees—mostly informal and illegal—when they returned.

Of course, the volatility of employment opportunities due to migration also affects women disproportionately. When oil prices declined in 1982, the labor market in the Gulf States crashed and net emigration in **Sri Lanka** probably became negative, adding to the domestic labor force. This helps explain why the income of the poor stagnated during that period.

CHAPTER EIGHT
POVERTY REDUCTION AND THE INTERNATIONAL DONOR COMMUNITY

The World Bank Group, according to its Web site and publicity, is "working for a world free of poverty." The objective is chiseled in the granite over the main entrance at 1818 H Street, N.W., in Washington, D.C. As the largest and most influential donor agency, the World Bank's commitment to ending poverty alerts the entire development community that the end product of economic growth is not that countries and individuals become rich but that both the process and resources generated end up freeing everyone from poverty.

This guide is a small part of that process, but there should be no misunderstanding about its role. As part of a coherent strategy to reduce poverty, this guide can lead USAID resources and strategic focus toward an integrated effort. In most countries, other donors individually—and, in virtually all countries, other donors in combination—will play a larger and more visible role in poverty reduction than will USAID. It is important, then, for USAID officials to understand what the other donors are doing. That is the purpose of this chapter. The Pro-Poor Growth Research Studies report *Poverty Reduction Strategy Papers: A Preliminary Analysis of the Process and Outputs* examines this topic in much greater detail and is included on the CD-ROM that accompanies this guide.

THE POVERTY REDUCTION STRATEGY PAPER PROCESS

The main vehicle for donor coordination on poverty reduction—and for buy-in by the countries themselves—is the Poverty Reduction Strategy Paper (PRSP). The process of preparing PRSPs began with considerable fanfare in 1999 as a mechanism to guide the resources being freed by the Heavily Indebted Poor Countries (HIPC) initiative, but quickly came to be seen as a much broader tool for linking World Bank and IMF funding to visible poverty reduction. A September 2003 review of the process by the IMF and the World Bank[17] starts as follows:

> **The PRSP approach has gained widespread support.** The total number of PRSPs has reached 32, with 14 PRSPs completed since the last report. There have also been a further six annual PRSP progress reports (PRSP-PRs), bringing the total to 11 by 7 countries. Another 21 countries have embarked on the PRSP process, having finalized their Interim Poverty Reduction Strategy Papers (I-PRSPs).

The PRSP process is important because it links three integral elements of poverty reduction:

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[17] IMF/World Bank (2003). *Poverty Reduction Strategy Papers—Detailed Analysis of Progress in Implementation,* September 15, 2003, Washington, D.C.: IMF/World Bank.

- A commitment by countries themselves to policies and budget resources directed at poverty reduction;

- A commitment by the major development donors to coordinate their own poverty-oriented activities around the PRSP process; and

- A globally accepted set of measurable objectives for poverty reduction as articulated in the Millennium Development Goals.

The difficulty with this vision, of course, lies in its implementation. The IMF/World Bank progress report is optimistic about the potential but realistic about the challenges:

> **The PRSP, however, is an instrument charged with multiple objectives, many of which result in tensions**—for example, long-term ambition versus budget constraints, comprehensiveness in addressing the different dimensions of poverty versus focus and prioritization, meeting the expectations of the international community versus country ownership and implementation capacity.
>
> **The tensions particularly manifest themselves in the following respects:**
>
> There are concerns about the breadth of the government's commitment beyond the team responsible for preparation, reinforcing the need for greater cohesion between PRSPs and other planning documents;
>
> Countries continue to find it a challenging task to strike the appropriate balance between ambition and realism in setting PRSP targets;
>
> Weak PEM [public expenditure management] and difficulties in linking PRSPs to the budget strain countries' administrative capacities;
>
> Lack of prioritization, which has resulted in inadequate focus, is often a significant problem, diminishing the potential value of the documents for both national authorities and donors; and
>
> There is an urgent need to improve donor alignment and harmonization around national strategies, in order to achieve successful implementation of PRSPs.

It is this "urgent need" that is relevant to this guide.

DONOR COORDINATION

One main objective of the PRSP process was to provide a mechanism by which donors and countries could align their strategies for poverty reduction and work in a coordinated fashion without taxing limited bureaucratic capacities of developing countries. The Rome Declaration on Harmonization in February 2003 presented the principles of good practice and standards of alignment and harmonization that had been developed by the Donor-Practices Task Force and the multilateral development bank working groups of the Organization for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC). The result is a commitment to support country-owned strategies, reliance on partner government systems as far as possible, shared interests in appropriate use of public funds, and the need to adapt to local circumstances.

Little of this potential coordination has actually been seen in the field, even in the judgment of the IMF/World Bank 2003 progress report. Although in principle there is clear agreement that countries themselves should take the lead in coordinating donor activities around their own poverty reduction strategies, the reality has been very weak leadership in this arena. The reasons for this problem are many, but lack of commitment is a clear barrier in some countries and lack of technical expertise in many others.

MONITORING AND EVALUATION

The now annual IMF/World Bank progress reports on PRSP implementation are an important first step in monitoring and evaluating the PRSP process narrowly and the results in poverty reduction more broadly. Further, the UNDP has undertaken the task of providing a common framework (and accessible Web site) for monitoring the implementation of all eight objectives of the Millennium Development Goals, including, specifically, progress on reducing the income and nonincome dimensions of poverty.[18] Many countries themselves have long had programs to carry out statistical monitoring of poverty and analytical units to figure out what the statistics mean. What more needs to be done?

First, there is a growing realization that most activities of government, indeed, most activities of private and NGO agents, have direct and indirect effects on poverty. It would be desirable to monitor and evaluate the impact of these activities as well as the specific activities undertaken as part of the PRSP process. A new approach, poverty and social impact analysis (PSIA), has been initiated in response to these concerns. PSIA also looks well beyond income poverty in its efforts to analyze the effects of policy interventions and other activities on the well-being of the poor and vulnerable. More on this approach is available on the World Bank's PSIA Web site (see "Web Sites" section below).

Second, despite the good record in some countries, there is a shocking lack of sound statistical data on the magnitude and location of poverty in developing countries. This is particularly true of the transition economies of Eastern Europe and the former Soviet Union (the Ukraine country case study illustrates this point). Even in countries that have taken poverty reduction seriously for decades, such as Sri Lanka, the available statistical series are

[18] The eighth goal involves the promises rich countries made as part of the Millennium Development process and is monitored by the Center for Global Development in its "Commitment to Development Index." Details are available at www.cgdev.org.

incomplete and inconsistent (see the Sri Lanka country case study). As part of a coordinated donor strategy of poverty reduction, funding to improve the statistical base of knowledge should have high priority.

Third, there is little analytical capacity to monitor and evaluate poverty trends in developing countries. Already, the World Bank and the Department for International Development have discovered they are stretched thin trying to conduct just a handful of PSIAs. A strong training program to build capacity to conduct such analyses is badly needed.

THE ROLE OF USAID

Where does USAID fit into this perspective on donor coordination of poverty reduction strategies? So far, the agency's presence has been little felt in either the discussions or implementation of PRSPs. The major regional reviews of experience being conducted by the IMF, the World Bank, the UNDP, and regional development banks have had no input, or even attendance, from USAID in any official capacity. A major research effort by the World Bank to operationalize pro-poor growth, obviously a parallel activity to the USAID Pro-Poor Growth Research Studies, became aware of the USAID activity serendipitously. At a minimum, USAID's new interest in this activity needs to be put on the agendas of the other major donors.

One vehicle for donor coordination does have USAID in a leading role: the DAC Informal Network on Poverty Reduction, known as POVNET. The DAC has long been the standing forum for the OECD bilateral donor community. Formed in June 1998, POVNET's first major effort was the *Scoping Study of Donor Poverty Reduction Policies and Practices* (2000). The *Scoping Study* proved to be a rich source of information on the strengths and shortcomings of donor efforts to reduce poverty, leading to POVNET's second major contribution, the DAC *Guidelines on Poverty Reduction* (April 2001).

The chair of POVNET in 2003–2004 is USAID Assistant Administrator Emmy Simmons. The U.S. representative to POVNET is Tim Mahoney, Director of the USAID Office of Poverty Reduction. With USAID at the helm, POVNET's 2003–2004 strategy is focused on pro-poor growth. Three working groups are examining agriculture and pro-poor growth, the role of the private sector in pro-poor growth, and infrastructure and pro-poor growth, respectively. The U.S. heads the working group on agriculture.

USAID's visible role in POVNET offers a major opportunity for institutional leadership around USAID's priorities and understanding of the basic causes of poverty. But challenges remain. In the countries where USAID has active field missions, professional staff need to be charged with participating in the PRSP process. One purpose of this guide is to provide such staff with the tools, framework, and further resources needed to participate effectively. At the moment, no one looks to mission-based USAID staff to provide intellectual leadership to the poverty reduction process in their countries. That needs to change.

POVERTY REDUCTION AND THE INTERNATIONAL DONOR COMMUNITY RESOURCES

For Further Reading

Development Assistance Committee (2000). *Scoping Study of Donor Poverty Reduction Policies and Practices,* Paris: Organization for Economic Cooperation and Development.

Development Assistance Committee (2001). *Guidelines on Poverty Reduction,* Paris: Organization for Economic Cooperation and Development.

The International Monetary Fund and the World Bank (2003). *Poverty Reduction Strategy Papers—Detailed Analysis of Progress in Implementation,* approved by Timothy F. Geithner and Gobind Nankani, September 15, 2003. www.imf.org/external/np/prspgen/2003/091503.htm.

The Journal of Economic Perspectives, 17(3), Summer 2003. Symposium on Global Poverty Reduction. Articles include: Timothy Besley and Robin Burgess, "Halving Global Poverty," pp. 3-22, and William Easterly, "Can Foreign Aid Buy Growth?" pp. 23-49.

Pottebaum, David (2002). *Poverty Reduction Strategy Papers: A Preliminary Analysis of the Process and Outputs,* Deliverable 7, USAID Pro-Poor Economic Growth Research Studies and Guidance Manual Activity, Bethesda, Md.: Development Alternatives, Inc., and Boston Institute for Developing Economies.

Web Sites

www.worldbank.org/poverty
This section of the World Bank's **PovertyNet** is dedicated to poverty reduction strategies and PRSPs. PRSPs describe a country's macroeconomic, structural, and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs. PRSPs are prepared by governments through a participatory process involving civil society and development partners, including the World Bank and the IMF. PovertyNet contains the full *Poverty Reduction Strategy Sourcebook*.

www.worldbank.org/psia
The World Bank's **Poverty and Social Impact Analysis (PSIA)** Web site contains a wealth of information, tools, and resources for PSIAs. The site contains concrete examples and case studies of PSIAs to highlight the PSIA systematic analytic approach, not a separate product. It starts with an ex-ante analysis of the expected poverty-related and social impacts of policy reforms, with a view to helping design the reforms. PSIA then advocates monitoring results during implementation. Finally, where possible, PSIA suggests evaluating ex-post the poverty and social impacts of reforms.

www1.oecd.org/dac/poverty
This is the home page of **POVNET**, the OECD Development Assistance Committee's Informal Network on Poverty Reduction. The site contains links to online resources including the *Scoping Study* (2000), the *Guidelines on Poverty Reduction* (2001), various meeting documents, and other background materials.

www.asiapropoor.net
This is the Web site of the UNDP's regional program **The Macroeconomics of Poverty Reduction**, designed to build on the lessons from the South Asia Poverty Alleviation Program and other major national poverty reduction programs across the Asia-Pacific region over the past decade. It seeks to identify growth-oriented stabilization policies and pro-poor adjustment policies. The assessment component of the program seeks to develop workable systems that will help countries link reported trends in poverty to the impact of national policies and strategies. During the first phase of operation (2002 to 2003), this initiative covers nine countries: Bangladesh, Cambodia, China, Indonesia, Mongolia, Myanmar, Nepal, Sri Lanka, and Vietnam. Based on the results of this phase and the availability of funds, additional countries will be included in a second phase, in 2004 to 2005.

www.adb.org/poverty
This is the **Asian Development Bank** portal for poverty reduction policies, strategies, and activities. The ADB Poverty Reduction Strategy is based on three pillars: pro-poor growth, social development, and good governance. This site also includes a link to all papers presented at the Asia-Pacific Poverty Forum in February 2001.

www.developmentgoals.org
The **Millennium Development Goals** Web site outlines the international community's commitment to an expanded vision of development, one that promotes human development as the key to sustaining social and economic progress in all countries, and recognizes the importance of creating a global partnership for development. The goals have been commonly accepted as a framework for measuring development progress. Many of the targets of the MDGs were first set out by international conferences and summits held in the 1990s. They were later compiled and became known as the International Development Goals. In September 2000, the member states of the United Nations unanimously adopted the Millennium Declaration. Following consultations among international agencies, including the World Bank, the IMF, the OECD, and the specialized agencies of the United Nations, the General Assembly recognized the Millennium Development Goals as part of the road map for implementing the Millennium Declaration.

ANNEX 1

GLOSSARY

GLOSSARY

This glossary presents some of the key terms relevant to the discussion of poverty and pro-poor growth.

Absolute Poverty: Absolute poverty means not being able to satisfy the minimum requirements for physical survival—food, clothing, and shelter. Absolute poverty lines are based on the cost of a basket of goods that satisfies only essential food and nonfood needs.

Basic Needs: Basic needs are usually defined as items of private consumption (adequate food, shelter, clothing, household equipment, and furniture) together with essential community services (safe drinking water, sanitation, public transport, health, education, and cultural facilities). The term was promoted by the International Labour Organization in the 1970s. It has to some extent been superseded by the term "human development."

Capacity Building: A coordinated process of deliberate interventions to upgrade skills, improve procedures, and strengthen organizations. Capacity building refers to the investment in people, institutions, and practices that will enable countries to achieve their development objectives. Capacity is effectively built when such activities contribute to the achievement of national goals while donor aid dependence decreases.

Chronic Poverty: Chronic poverty (also called "persistent poverty") is intractable poverty that results from long-term structural factors. Chronic poverty differs from severe poverty—people affected by disaster or conflict, for example, frequently experience severe poverty. In many cases severe poverty is transient; people eventually rebuild their lives and livelihoods. The chronic poor often experience several factors of being disadvantaged simultaneously. For example, low-caste widows living in remote areas in India experience sustained poverty through the interaction of gender, caste, age discrimination, and geographical location.

Direct and Indirect Impacts: Some policy reforms may have primarily direct impacts: those impacts that result directly from changes in the policy levers altered by the reform. For example, an increase in value-added tax will translate directly into a lower purchasing power for a given disposable income. Reforms may also have important indirect impacts, or those impacts resulting from the reform through channels other than the actual policy lever or action. An increase in value-added tax rates will have a positive impact on the fiscal stance of the country. If this is translated into increased government expenditure, it can have impacts on various groups of households through the goods, services, transfers, and subsidies they receive. A stronger fiscal stance will likely generate improved growth, affecting household welfare, another example of an indirect impact.

Dutch Disease: Dutch Disease is the adverse effect on a country's industries when the discovery of a natural resource causes a real appreciation of a country's currency. This makes manufactured goods less competitive with those of other nations, increasing imports and decreasing exports. The phenomenon is named after what happened to the Dutch economy after natural-gas discoveries in the North Sea. The term is most commonly applied to the effects of natural resource exports on the manufacturing sector.

Endogenous: Generated by internal as opposed to external (exogenous) factors. Endogenous effects include technological change or economies of scale.

Exogenous: Generated by external as opposed to internal (endogenous) factors. Exogenous effects include natural disasters or regional economic crises.

Ex-ante Analysis: Analysis carried out before policy changes take place, typically by "simulating" events and "forecasting" the impacts of these changes.

Ex-post Analysis: Analysis carried out after a policy change has been implemented, by examining actual events.

Gini Coefficient: The Gini coefficient gives a rough measure of the amount of inequality in the income distribution by measuring the area between the Lorenz curve and the 45-degree equality line. This area is divided by the entire area below the 45-degree line (which is always exactly one-half). For a perfectly equal distribution, there would be no area between the 45-degree line and the Lorenz curve, resulting in a Gini coefficient of zero. For hypothetical complete inequality, in which only one person has any income, the Lorenz curve would coincide with the straight lines at the lower and right boundaries of the curve, so the Gini coefficient would be one. Gini coefficients for real economic systems fall between zero and one.

Human Development: A position championed by the United Nations Development Programme in the *Human Development Reports* that emphasizes enriching people's lives as the primary objective of development. In this view, progress should be measured in terms of capabilities and not in terms of money-based measures such as incomes or expenditures.

Income Poverty: The lack of sufficient income or expenditure to meet minimum consumption needs. Also called "monetary poverty," this is but one aspect of broader, more multidimensional definitions of poverty and deprivation (see also "Livelihood").

Institutions: Institutions are the formal or informal rules governing peoples' and organizations' behavior. Institutions are "the rules of the game," differing from organizations, which, along with individuals, are "the players of the game." Formal institutions (such as by-laws, national laws, policies, national constitutions, and international laws and treaties) are part of the institutional environment and distinct from institutional arrangements. Informal institutions include social customs and conventions.

Labor Market: The "labor market" is a labor economics term indicating the exchange between the demand and supply of labor for a nation, region, industry, and/or occupation. The outcomes of this process include the level of (un)employment, wages, and employment conditions.

Livelihood: A livelihood comprises the capabilities, assets, and activities required for a means of living. A livelihood is sustainable when it can cope with and recover from stresses and shocks while maintaining or enhancing its capabilities and assets both now and in the future, without undermining its natural resources base. The Department for International Development (DFID) sustainable livelihoods framework focuses on five types of capital: human, financial, natural, social, and physical.

Lorenz Curve: The Lorenz curve maps the cumulative income (or expenditure) share against the distribution of the population. If each individual had the same income, or total equality, the income distribution curve would be a straight line in the graph.

Millennium Development Goals: The eight MDGs commit the international community to an expanded vision of development, promoting human development as the key to sustaining social and economic progress in all countries. The goals have been commonly accepted as a framework for measuring development progress. Many of the targets of the MDGs were first set out by international conferences and summits held in the 1990s. They were later compiled and became known as the International Development Goals. In September 2000 the member states of the United Nations unanimously adopted the Millennium Declaration. Following consultations among international agencies, including the World Bank, the International Monetary Fund, the OECD, and the specialized agencies of the United Nations, the General Assembly recognized the MDGs as part of the road map for implementing the Millennium Declaration.

Poverty Gap Index: The poverty gap index measures the depth of poverty considering both the number of poor people and how poor they are. The Poverty Gap Index is the combined measurement of incidence of poverty (headcount) and depth of poverty.

Poverty Headcount Index: The poverty headcount index (also called the "incidence of poverty") describes the percentage of the population whose per capita incomes, or expenditures, are below the poverty line. In other words, it is the population that cannot afford to buy a basic basket of goods.

Poverty Reduction and Growth Facility (PRGF): The PRGF, established in 1999, is the IMF's low-interest lending facility for poor countries. Through the PRGF, the International Monetary Fund (IMF) aims to integrate the objectives of poverty reduction and growth more fully into its operations among its poorest members. PRGF-supported programs are designed to cover only areas within the primary responsibility of the IMF, unless a particular measure is judged to have a direct, critical macroeconomic impact. Areas typically covered by the IMF include advising on prudent macroeconomic policies and related structural reforms, such as exchange rate and tax policy, and on better fiscal management, budget execution, fiscal transparency, and tax and customs administration.

Poverty Reduction Strategy Papers (PRSPs): PRSPs describe a country's macroeconomic, structural, and social policies; its strategies and programs to promote growth and reduce poverty; and associated external financing needs. PRSPs are prepared by governments through a participatory process involving civil society and development partners. The PRSP process is coordinated by the World Bank and the IMF.

Poverty Reduction Support Credit (PRSC): The PRSC is a World Bank lending instrument available to eligible IDA borrowers. The PRSC provides support for the implementation of a country's poverty reduction strategy and the associated program of social, structural, institutional, and policy reforms. The PRSC is grounded in the principles of the Comprehensive Development Framework (CDF) and the International Development Goals.

Poverty and Social Impact Analysis (PSIA): A PSIA is an analysis of the intended and unintended consequences of policy interventions (ex-ante, during implementation, and ex-post) for the well-being of different social groups, with a particular focus on the poor and vulnerable.

Pro-Poor Economic Growth: Strictly defined, pro-poor economic growth implies growth with an improvement of income distribution in favor of the poor. A weaker definition has the poor sharing in rapid economic growth to a substantial extent (though not necessarily more than the nonpoor). A pro-poor growth strategy as defined in this guide would seek to increase the growth rate of the incomes of the poor by increasing the growth rate of the economy and by increasing the extent to which that growth rate benefits the poor.

Public Works: Government-funded projects to develop or maintain physical infrastructure. These are largely labor-intensive in nature.

Relative Poverty: Relative poverty is defined in relation to average income or expenditure levels or societal norms. A relative poverty line can be set as a fraction of the national average income, for example.

Safety Nets: Safety nets are mechanisms that mitigate the effects of poverty and other risks on vulnerable households. Risks can be temporary or permanent, and they can also be idiosyncratic, affecting specific households (such as illness or death of a breadwinner), or covariate, affecting communities and countries (such as drought and a shift in terms of trade). A variety of safety nets address these risks, including private or informal ones, such as when family members in different households support each other through hard times with cash, food, or labor. Others are formal programs run by governments and others that aim to provide additional income or in-kind help to vulnerable households.

Social Assistance: A range of benefits in cash or kind to provide protection for the most vulnerable persons in society. These programs are usually financed from government revenues.

Social Capital: The social capital of a society concerns the institutions, relationships, attitudes, and values that govern interactions among people and contribute to economic and social development. It includes the shared values and rules for social conduct expressed in personal relationships, trust, and a common sense of civic responsibility, which all together make a society more than just a collection of individuals.

Social Insurance: Social insurance cushions the risks associated with unemployment, disability, work injury, and old age. These programs are usually tied to replace a specified percentage of a worker's previous earnings, with the percentage a function of work years, level of pay, and, often, social criteria such as family size and credit for certain nonwork periods (for example, child care or registered unemployment) or below-average earnings. These programs may be contributory or noncontributory.

Social Protection: Social protection is a collection of measures to improve or protect human capital, ranging from labor market interventions, publicly mandated unemployment, or old-age insurance to targeted income support. Social-protection interventions assist individuals, households, and communities to better manage the income risks that leave people vulnerable.

Stakeholders: Stakeholders include all individuals and groups who are affected by, or can affect, a given operation. Stakeholders can be individuals, interest groups, or corporate organizations.

Targeting: The goal of targeting is to deliver more resources to the poorest groups of the population. Because targeting has costs and benefits, decisions about whether and how to target, how precise to be, and what method to use will depend on the relative size of these costs and benefits, which will vary by setting. Targeting methods include individual assessment mechanisms (such as means tests), group or geographic targeting (where candidates share an easily identifiable characteristic), and self-targeting (where the service is in theory available to all but is designed in a way that discourages the nonpoor from using it, such as setting low wages in public works programs and subsidizing only low-quality goods).

Transient Poverty: A situation in which an individual is poor because of some temporary shock that could be reversed over time.

Vulnerability: Vulnerability denotes a condition characterized by greater risk for, and reduced ability to cope with, shock or negative impacts. It may be based on socioeconomic condition, gender, age, disability, ethnicity, or other criteria that influence people's ability to access resources and development opportunities. Major risk factors are environmental risk, market risk, political risk, social risk, and health risk. Seasonality may play a large role in vulnerability. The concepts of poverty and vulnerability overlap but are not the same.

ANNEX 2

ANNOTATED LIST OF POVERTY AND GROWTH WEB SITES

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www.adb.org/poverty
The **Asian Development Bank** portal for poverty reduction policies, strategies, and activities. The ADB Poverty Reduction Strategy is based on three pillars: pro-poor growth, social development, and good governance. This site also includes a link to all papers presented at the Asia-Pacific Poverty Forum in February 2001.

www.asiapropoor.net
This is the Web site of the UNDP's regional program **The Macroeconomics of Poverty Reduction**, designed to build on the lessons from the South Asia Poverty Alleviation Program and other major national poverty reduction programs across the Asia-Pacific region over the past decade. It seeks to identify growth-oriented stabilization policies and pro-poor adjustment policies. The assessment component of the program seeks to develop workable systems that will help countries link reported trends in poverty to the impact of national policies and strategies. During the first phase of operation (2002 to 2003), this initiative covers nine countries: Bangladesh, Cambodia, China, Indonesia, Mongolia, Myanmar, Nepal, Sri Lanka, and Vietnam. Based on the results of this phase and the availability of funds, additional countries will be included in a second phase, in 2004 to 2005.

www.chronicpoverty.org
The **Chronic Poverty Research Center** is an international partnership of universities, research institutes, and NGOs established in 2000 with initial funding from DFID. Based at the Institute for Development Policy and Management, University of Manchester, the Web site contains poverty working papers, a research-methods toolbox, and a bibliographic database with nearly 4,000 references as of September 2003.

www.developmentgoals.org
The **Millennium Development Goals** Web site outlines the international community's commitment to an expanded vision of development, one that promotes human development as the key to sustaining social and economic progress in all countries, and recognizes the importance of creating a global partnership for development. The goals have been commonly accepted as a framework for measuring development progress. Many of the targets of the MDGs were first set out by international conferences and summits held in the 1990s. They were later compiled and became known as the International Development Goals. In September 2000, the member states of the United Nations unanimously adopted the Millennium Declaration . Following consultations among international agencies, including the World Bank, the IMF, the OECD, and the specialized agencies of the United Nations, the General Assembly recognized the Millennium Development Goals as part of the road map for implementing the Millennium Declaration.

http://econ.worldbank.org/programs/poverty/topic/2543
This **World Bank Poverty Research Program** Web site houses the "Pro-Poor Growth" subtopic. Looking Beyond Averages: A Poverty Research Program is managed by Martin

Ravallion. This subtopic site includes discussion of pro-poor growth and a selection of documents and research papers from the Pro-Poor Growth library.

www.livelihoods.org
Livelihoods Connect is funded by the United Kingdom's Department for International Development (DFID) and maintained by the Institute of Development Studies, University of Sussex (IDS). The Web site synthesizes and organizes information relevant to DFID's work on sustainable livelihoods. The "Information Resources" section contains guidance sheets, distance-learning materials, key documents, events, and organizational links.

www1.oecd.org/dac/poverty
This is the home page of **POVNET**, the OECD Development Assistance Committee's Informal Network on Poverty Reduction. The site contains links to online resources, including the *Scoping Study* (2000), the *Guidelines on Poverty Reduction* (2001), various meeting documents, and other background materials.

www.worldbank.org/poverty
PovertyNet is maintained by the World Bank's Poverty Reduction Group, part of the Poverty Reduction and Economic Management Network. The comprehensive site contains a wealth of information and serves a range of users by providing both broad introductions to key issues regarding poverty and more detailed analyses and data for researchers and practitioners.

www.worldbank.org/psia
The World Bank's **Poverty and Social Impact Analysis (PSIA)** Web site contains a wealth of information, tools, and resources for PSIAs. The site contains concrete examples and case studies of PSIAs to highlight the PSIA systematic analytic approach, not a separate product. It starts with the ex-ante analysis of expected poverty and social impacts of policy reforms, with a view to helping design the reforms. PSIA then advocates monitoring results during implementation. Finally, where possible, PSIA suggests evaluating ex-post the poverty and social impacts of reforms.

www.worldbank.org/safetynets
This site houses the **World Bank Social Safety Nets Primer,** launched in December 2003. The primer is intended to provide a practical resource for those engaged in the design and implementation of safety net programs around the world. Readers will find information on good practices for a variety of types of interventions, country contexts, themes, and target groups, as well as the current thinking of specialists and practitioners on the role of social safety nets in the broader development agenda. Primer papers are designed to reflect a high standard of quality as well as a degree of consensus among the World Bank Safety Nets Team and general practitioners on good practice and policy.

ANNEX 3

POVERTY MEASUREMENT: A PRIMER

POVERTY MEASUREMENT: A PRIMER

Chapter One of this guide outlines in very broad terms the evolution of thinking on poverty. It shows that different poverty definitions have different policy implications. The choice of poverty definition also has consequences for poverty measurement. An important trade-off in poverty assessment is that the broader the definition of poverty, the more difficult it becomes to measure. This annex reviews some of the basic concepts in poverty measurement.

Why do we measure poverty? Poverty assessments are the basis for poverty reduction strategies. Numbers on the extent, severity, and location of poverty are used to formulate social policy, to monitor the impact of projects, to determine future programming, to allocate scarce resources, to target social protection programs, and, more generally, to reflect upon a country or region's overall level of development. Unfortunately, the numbers are not always straightforward.

Poverty measurement can be political. When looking at poverty figures, a few questions are key. Who produced the poverty numbers, what exactly did they measure, and how did they measure them and why? The answers all will influence the final result, so statistics have to be read with caution. This becomes all-important when one wishes to make comparisons of poverty over time. In order to draw meaningful conclusions about what has happened to the poor, one must be certain that the same measurement methodology was applied to arrive at the figures to be compared. The potential for variation is quite large, as the next section will demonstrate.

FOUR STEPS FOR POVERTY MEASUREMENT

Four broad steps are needed to arrive at a measure of poverty:

1. Choose a dimension and indicator of poverty,
2. Select a data source,
3. Define a poverty line, and
4. Decide on a poverty measure.

Choosing the Dimension and Indicator of Poverty

The most commonly measured dimension of poverty is the monetary dimension, also called *income poverty*. Here, the indicator of well-being can be either income or consumption (that is, expenditure). Most analysts will agree that consumption is a better indicator than income because consumption is a better outcome indicator, and better reflects a household's living standards. Consumption is a better proxy for permanent income than yearly income, which can fluctuate. On the other hand, using consumption instead of income masks the temporary cycles of poverty. People might sell assets in order to be able to survive during a drought or a recession, for example. If one were interested in the impacts of adjustment, income would be the better indicator. No matter which monetary indicator is chosen, there are problems with collecting high-quality monetary data in general. Recall data—where respondents are asked to remember detailed financial information—become more problematic the longer the recall period. Survey respondents may also conceal sources of income for fear of repercussions (taxation, for example).

The nonmonetary dimensions of poverty are measured using a host of different indicators: health, nutrition, education and literacy levels, housing characteristics, other asset indices, and so on.

Selecting Data Sources

Most poverty measures are based on data from household surveys carried out by central statistical agencies. Different types of individual and household-level data can be gleaned from household income and expenditure surveys, the census, demographic and health surveys, and multitopic household surveys. Multitopic welfare surveys such as the World Bank's Living Standard Measurement Surveys (LSMSs) are particularly useful for poverty analysis. Consumer and producer prices are important for comparison over time.

It is important to assess the quality of the data source. Is the sampling frame representative? Were equivalence scales used to aggregate individual data to the household level? Was the survey methodology consistent between rounds? Does the measure of household resources include access to common property resources? How is the home-production of foodstuffs valued? These are just a few of the essential questions.

The question of equivalence scales is particularly important. In household surveys, income is declared at the household level, but poverty can be expressed in terms of either the percentage of households or the percentage of individuals under the poverty line. This requires some decisions about the basic needs of different members of the household, by age and gender. In an equivalence scale, the members of the household are expressed as adult equivalents, where the needs of male and female household members of various ages are expressed as a fraction of those of the average adult male. Effective household size is thus not the number of persons but the number of adult equivalents.

Setting Poverty Lines

The choice of a poverty line will have a major effect on who is considered poor. The main problem with poverty lines is that dividing lines must be drawn where none may be obvious, lending an inevitable degree of arbitrariness. Depending on the definition of poverty, a poverty line can be set in either a relative, absolute, or subjective manner.

Relative Poverty Lines

Relative poverty lines are usually defined in relation to the income (or expenditure) distribution in a country. In Western Europe, for example, poverty lines are often set at 50 percent of a country's average income. In Ukraine, the official poverty line is 75 percent of the median expenditure. A second way to measure relative poverty is with respect to various commodities. This measure determines households to be poor if they are lacking certain commodities that are common to the society in which they live.[1]

Absolute Poverty Lines

Absolute poverty lines are far more common than relative poverty lines and are thought to be more objective (and relevant to developing countries, where physical survival may be at stake). An absolute poverty line does not depend on income distribution in a society but is chosen to reflect some fixed level of resources needed to sustain life and health. This involves setting minimum consumption norms for both food and nonfood items and translating them into a required income or expenditure level. There are many ways to do this.

In the estimation of food needs alone there are frequent conflicts among nutritionists about how dietary allowances should be translated into food baskets. What particular food items should satisfy calorie requirements—low-cost goods or the foods people actually consume? Deciding what minimum nonfood items people require can be even more problematic. In a sense, this is where the absolute and relative approaches begin to blur, because nonfood needs will depend on geographic and sociocultural circumstances.   Some absolute poverty lines are based on a minimum-needs food basket, the value of which is scaled up to reflect the overall proportion of income that ought to be spent on food.[2]

To combat many of these methodology problems, the World Bank developed the international $1-a-day poverty line, now also used to monitor achievement of the Millennium Development Goals. Often multiple poverty lines will be set, for example to assess poverty (inability to meet food plus nonfood needs) and extreme poverty (inability to meet even food needs alone).

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[1] For example, researchers in Holland constructed an index using four durable goods: ownership of a car, color television, refrigerator, and washing machine. See Hagenaars, Aldi and Klaas de Vos (1988), "The Definition and Measurement of Poverty," in *Journal of Human Resources*, v. 23, n. 2, pp. 211-221.

[2] This method uses the concept of the food ratio, based on the observation by Engel in 1857 that there is an inverse relationship between income and the percentage of total expenditure allocated to food. By examining the proportion of a family budget spent on food, an Engel coefficient can be computed. In Mollie Orshansky's work to determine the original poverty line in the United States in the 1960s, she found that the average household spent about one-third of its budget on food. Thus, a food ratio of more than a third meant a family could be considered poor. For more on the evolution of U.S. poverty thresholds, see http://www.census.gov/hhes/www/poverty.html.

Subjective Poverty Lines

Subjective poverty lines are set by asking respondents to judge minimum standards and needs. These judgments may be general (How much money does a family of two adults and two children need to get by each month?) or specific (What does your family need to survive each month?). Subjective poverty lines evolved out of the use of participatory methods, where local understanding and experience of poverty is paramount. A simple subjective poverty assessment has respondents answer the simple yes/no question: Is your family poor?

Deciding on Poverty Measures

Three of the most basic poverty measures are the poverty headcount index, the poverty gap, and the squared poverty gap. These three measures make up the Foster-Greer-Thorbecke class of poverty measures.

The Poverty Headcount Index

The headcount index is also known as the incidence of poverty. This is a simple measure of the share of the population (or of households) whose income (or expenditure) falls below the poverty line. A person could be just below the poverty line or very far below the poverty line and it would make no difference to the headcount index. In the formula below, the headcount "H" is defined as the proportion of the population for which consumption or income "y" is less than the poverty line "z." If we have a population of size "n" in which "q" people are poor, the headcount index is defined as follows:

$$H = \frac{q}{n}$$

The Poverty Gap

The poverty gap measures the percentage by which the income of the poor falls below the poverty line. It is defined as follows:

$$PG = \frac{1}{n}\sum_{i=1}^{q}\left(\frac{z-y_i}{z}\right)$$

where "y_i" is the income of individual "i," and the sum is taken only for those individuals who are poor ("q").

The poverty gap measure is useful because it reflects the depth of poverty, which the headcount index does not. It is also useful because by a simple transformation it can be used to tell how much it would cost as a fraction of gross domestic product to lift all poor people out of poverty through perfectly targeted cash transfers. If we multiply "PG" in the above equation by "z/y" where "$\bar{y}$" is average per capita income, we get the total difference between the income of the poor and the poverty line, known as the poverty gap, expressed as a fraction of GDP. So, for example, if the poverty line is equal to one-third of per capita income in a country and PG is 6 percent, it will cost 2 percent of GDP to eliminate poverty by perfectly targeted transfers. This is a useful indicator of how great an effort would be required to eliminate poverty through well-targeted transfer programs.

The Squared Poverty Gap

The squared poverty gap measures poverty severity. Whereas the poverty gap measures the distance separating the poor from the poverty line, the squared poverty gap is the square of that distance. This places a higher weight on those households that are farther away from the poverty line, thus taking changes in incomes among the poor into account. The squared poverty gap is obtained as follows:

$$P2 = \frac{1}{n}\sum_{i=1}^{q}\left(\frac{z - y_i}{z}\right)^2$$

THE PITFALLS OF POVERTY MEASUREMENT

This annex has briefly outlined the steps involved in arriving at poverty estimates. The key lesson is that the amount of potential variation in methodology is so large that it can make the interpretation of figures very difficult indeed. For example, a study might report a country's poverty incidence at 25 percent. Without the methodological details of this poverty headcount, however, it is impossible to know whether the 25 percent is a measure of the proportion of the families (or of the individuals) that have an income or an expenditure that is too low to survive (extreme poverty) or too low to avoid deprivation (poverty) or too low to enjoy a socially acceptable standard of living (relative poverty). It cannot be overemphasized how important it is to know what exactly is being presented, as the numbers can differ widely.[3] More than a few analysts have been confused by the wealth of conflicting figures available.

Small changes in methodology can lead to significant differences in the resulting poverty levels. Changes over time must be therefore be interpreted very carefully, ensuring that the basic building blocks of the poverty measure are the same. When examining pro-poor economic growth and monitoring the effects of policies on poverty reduction, one must note that apparent changes in poverty estimates might simply be a result of a change in the way in which poverty was measured.

[3] This does not include alternative poverty measures (for example, those that go beyond income with more qualitative, multidimensional approaches). These result in even more conflicting figures.

Poverty Measurement Resources

For Further Reading

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ANNEX 4

COUNTRY STUDIES: EXECUTIVE SUMMARIES

COUNTRY STUDIES: EXECUTIVE SUMMARIES

AFRICA

Uganda

Uganda was a "basket case" in 1986, when the National Resistance Movement under Yoweri Museveni came to power through a successful guerrilla war. The country had suffered from more than 15 years of misrule, violence, and pillaging of economic resources by Idi Amin, Milton Obote, and short-lived military regimes. Real GDP had declined by more than 40 percent, and the response of the populace was to retreat from formal-sector economic activity into primarily subsistence production. The government lost the ability to mobilize resources through an orderly fiscal system, foreign exchange was unavailable, and high levels of inflation were the result of uncontrolled expansion of the money supply through financing deficits. The influential Asian commercial group had been expelled by Amin in 1972, resulting in capital flight and a collapse of the country's established trading systems.

The Museveni government, which has been in power for the past 16 years, has made remarkable progress. First, order was restored in most of the country and a relatively disciplined army was created. Then, early reconstruction, particularly of devastated coffee-producing areas, was undertaken. Gradually, economic growth became positive, inflation rates declined to moderate levels, private investment expanded, and coffee exports recovered.

A critical step was taken in 1992, when a strategy for macroeconomic policy was adopted and implemented by an extraordinarily capable group of "technocrats" within the Ministry of Finance, Planning, and Economic Development. The key policies were adopting a floating exchange rate, which eliminated the parallel-market premium; instituting a strict program of budget control, which also limited the expansion of the money supply; and dismantling the previous system of official controls on marketing coffee and cotton through monopsonistic cooperatives and marketing boards to allow free, private trade in purchasing and exporting crops. These, of course, are the standard policies that have been advocated in many structural adjustment programs in Africa and elsewhere, many of which have been unsuccessful.

From 1992 to 2000, per-capita real GDP in Uganda grew at almost 8 percent per annum. There was a bit of "good luck" with a temporary surge in world coffee prices as a result of frost in Brazil. It is clear, however, that the increase in world prices was transmitted to peasants through the newly competitive marketing system, and that there was a rise in marketed output. Private investment increased, as did government investment, particularly in infrastructure rehabilitation, with the help of international-donor assistance. The proof that this has been more than mere good luck is that even since coffee prices fell drastically, Uganda's growth has been sustained.

We have excellent data on household consumption from a series of national surveys that allow us to assess the degree to which poverty has been alleviated as a result of this growth. Using household measured consumption, a poverty line was constructed consistent with consumption of 3,000 calories daily per adult male equivalent. The proportion of Ugandans having consumption below this poverty line declined sharply, from 56 percent in 1992 to 35 percent in 2000. For rural areas, the decline was from 60 percent to 39 percent, and in urban areas, 28 percent to 10 percent. This remarkable achievement is not sensitive to the arbitrary choice of the poverty line because real per-capita consumption increased in every decile of income distribution. Inequality, measured by Gini coefficients, remained stable within both rural and urban areas, although the overall measure of inequality increased slightly as a result of net transfer of population from lower-income rural areas to higher-income urban areas. Poverty reduction arose from growth rather than from redistribution, and the benefits of growth were widely distributed.

Poverty rates declined in all sectors, but agricultural progress was the dominant factor. Between 1992 and 1996, 48 percent of the overall decline in poverty was experienced in the cash-crop sector, which accounted for 19 percent of the total population. This is not surprising, given the coffee boom of 1994 and 1995. However, between 1996 and 2000, the poverty rate declined dramatically in the food-crop sector and fell further in the cash-crop sector. Other sectors, being significantly smaller, accounted for much smaller shares of overall poverty reduction (for example, manufacturing, 3.7 percent; construction, 1.0 percent; and government services, 7.6 percent).

The primary channels through which policies have affected poverty reduction are the exchange rate and increased competitiveness in the liberalized trading system. Together, these caused prices received by peasant producers to increase dramatically, which both increased their income from existing production levels and provided incentives for expanded production. These effects were quite evident for producers of export crops. However, the even more important poverty reduction for food-crop producers is a bit surprising. It appears that the general improvement in transport and competitiveness of traders provided opportunities for peasant farmers to increase their production and marketing surpluses. In addition to increasing income from agricultural production, they also diversified their production and increased their participation in rural non-farm activities (principally trading and services).

Why has Uganda succeeded in reducing absolute poverty as a result of adopting “Washington consensus” structural-adjustment policies, when so many other countries have failed? First is the Ugandan commitment to the program and the fact that it was actually implemented. The structure of the economy also proved favorable. Uganda is overwhelmingly agricultural: Some 84 percent of the population is still classified as rural, and within the rural sectors, production is almost exclusively undertaken with family labor by smallholders. Land is relatively available, and the response to the crises of the 1970s and 1980s was the retreat into subsistence production. Even today, more than 80 percent of food grown by peasant families is for their own household consumption. The typical unit grows food for its own consumption and markets surpluses when market opportunities arise. Many also grow some cash crops. When inputs are available in markets, smallholders purchase implements, fertilizer, pesticides, and improved seeds and livestock. In addition to agriculture, the families engage in other small-scale trading and fabricating activities. Wage labor in rural areas is not widespread, and many agricultural families have members working elsewhere (principally in towns) and receive remittances from them.

In a crude sense, Uganda is highly rural and relatively egalitarian in terms of access to land. Therefore, increasing opportunities to produce surpluses for the market at prices that provide incentives have resulted in higher real income and consumption for peasants who have been able to respond. However, it is likely that the "easy" gains have been realized. Those remaining in poverty probably have specific characteristics that make them less able to respond.[4] There is also evidence that those who have increased their incomes the most in rural areas have had more education, better health care, and more assets such as livestock and land (Larson and Deininger, 2001). This is consistent with evidence from other countries in that poverty reduction is more widespread in regions where education and health-care levels are high and landlessness relatively low.

Uganda has adopted a well-thought-out poverty reduction strategy that has four pillars: sustaining economic growth and structural transformation, ensuring good governance and security, increasing the ability of the poor to raise their incomes, and improving the quality of life among the poor. The first two pillars are responsible for most of the progress that has been made in Uganda's poverty reduction. The restoration of security has played an important role, and the persistence of insecurity in the North explains its higher levels of poverty and lower rates of progress in reducing poverty.

A set of programs is now in the early stages of implementation for increasing the ability of the poor to raise their incomes. The programs include transport improvements, increased access to markets, microfinance, agricultural research and extension, and education. These represent the beginning of special programs targeted to the poor. It is too early to say how effective they will be, but the low performance of public institutions and the prevalence of corruption will pose obstacles to success. The existence of many locally based voluntary organizations may play a role. These institutions have been significant in dealing with the HIV/AIDS pandemic and represent a largely unrecognized pool of social capital that can be harnessed to help the poor.

Major programs, many with considerable donor assistance, have been devised to provide primary education, health-care services, and clean water and sanitation for the poor. So far, expenditures have increased considerably, but concerns remain about the effectiveness of these programs to increase the level and quality of services reaching the poor.

Uganda stands out in terms of the remarkable achievement it has made in recovering from violence, civil war, and economic collapse. Its high rates of growth in the 1990s have resulted in significant reductions in the incidence of extreme poverty. The government has been forthright in making poverty elimination its principal goal and formulating a coherent

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[4] See Bevan and Ssewaya (1995), for an interesting analysis of the social dimensions of poverty, and Republic of Uganda (2000a), for contemporary reports on which people are most disadvantaged.

strategy for achieving it. However, the remaining challenges are enormous, but there is reason to be optimistic and believe that progress can be maintained and even accelerated.

Zambia

The Zambian economy has experienced a severe decline in its fortunes since Independence in 1964: real GDP per capita has declined an astounding 42 percent and poverty incidence has increased, reaching 73 percent in 1998. The elections of 1991 ushered in the reformist-minded government of Chiluba, which was initially committed to undertaking deep reforms aimed at achieving sustainable growth and poverty reduction by transforming the Zambian economy from an inward-looking, state-dominated economy to an open, market-oriented, private sector driven economy.

The Chiluba government originally moved quickly forward with stabilization and certain aspects of structural adjustment and trade such as agricultural and financial liberalization. By the mid-1990's, the fundamental aspects of the reforms had been put in place. The reforms had some positive effects on the economy: hyperinflation was arrested (although inflation continues to hover around 20 percent); there was some diversification of an originally mono-crop agricultural sector; and financial deepening seems to be occurring, driving growth in parts of the service sector. Overall, growth and poverty outcomes since the initiation of reform have been mixed: average annual real GDP per capita decreased by close to 2 percent between 1991 and 2000, and the poverty incidence increased by more than 3 percent over the same period. Although the average growth trend between 1991 and 2000 as a whole has been discouraging, there has been a slight increase in real GDP per capita growth in the latter half of the 1990's. The modest but continuing growth acceleration since 1998 provides some grounds for optimism.

One obvious factor in Zambia's poor economic performance over the decade has been the continuing decline in revenues from copper throughout the decade. The growth of the non-copper sector has, in fact, been reasonably impressive since mid-decade- it has grown an average of approximately 5.5 percent per annum over the 1995-2001 period. During the early 1990's, the overvaluation, high interest rates, and disarray in agricultural policy were no doubt contributors to the stagnation of the non-copper sector. By the latter part of the 199s0s, the most negative of these effects had past and some of the benefits of stabilization and adjustment may have contributed to the decent growth that occurred. An additional drag on the economy's performance, albeit a hard one to measure quantitatively, has been the HIV/AIDS epidemic. Its negative impact probably increased as the decade went on.

Part of the blame for the weak GDP growth clearly lies with weaknesses in the design and implementation of Zambia's structural adjustment program (SAP). Little thought seemed to have been given to policy coordination and the proper pace and sequencing of reforms, so it was not uncommon for reforms that worked at cross purposes to be undertaken simultaneously.

The poor reform design was, in part, due to Zambia's adoption of the standard SAP model promoted by the IFIs at the time. This model was not tailored to the needs of the Zambian economy and was probably too simplistic: it merely pushed countries to stabilize and liberalize all sectors in short order. The example of trade liberalization in Zambia illustrates this point well. The total removal of protection during a time when the Kwacha was appreciating (as a result of the liberalization of the foreign exchange and capital markets) and neighboring countries were not complying with the negotiated trade agreements had a negative impact on the competitiveness of Zambian exporters. Zambia's experience calls into question the wisdom of failing to maintain some level of protection in context of an appreciating and ultimately overvalued exchange rate and of trading partners that do not comply with trade agreements.

The absence of a built-in mechanism to allow Zambia to adjust to external shocks (such as droughts and declining copper prices), is further evidence of a lack of sophistication of the SAP. The 1992 drought was more damaging than necessary to the economy and to rural poor in particular because the government continued its strict stabilization measures rather than adjust them to account of the shock. Clearly, the lack of a sophisticated, coordinated reform policy able to adjust to external shocks was highly problematic.

Apart from design and implementation problems in policy areas they did address, the reforms failed to focus adequately on the crux of Zambia's problem: the dire need to diversify away from copper dependence. In addition to diversifying its exports, it was important that on a more fundamental level Zambia diversify the structure of its economy. Agriculture was rightly seen as the sector with the potential to be a driving force in the economy and to reducing rural poverty. Agricultural policy, however, has been characterized by a lack of clarity throughout the 1990s. In order for the agricultural sector to achieve its potential in terms of contributing to economic growth and poverty reduction a systematic and comprehensive agricultural policy must be developed.

The SAP program also suffered from the government's exaggerated expectations regarding the ability of the private sector to fill the vacuum of the retreating public sector. The more than two decades of socialist policies had resulted in a small and weak private sector. In addition, unexpected results of the reform such as the prohibitively high cost of credit severely limited the potential for the private sector to engage in productive activities while providing them incentives to channel their resources toward unproductive investments (i.e., high-yielding, low-risk Treasury bonds). Further, uncertainty regarding government policy (especially in the maize market where it would intervene unpredictably) further discouraged an effective private sector supply response. Since the success of the reform was predicated upon such a response the private sector's modest capacity limited Zambia's growth potential.

Additionally, increasing government corruption and waning government commitment to reforms undermined the potential growth and poverty reducing impact of the reforms. Corruption had a pernicious effect on the economy because it converted potentially productive and poverty reducing resources into unproductive rents. The government's diminishing commitment to reforms was evident by the mid-1990s. By that point, the reforms had borne little fruit. This contributed to the loss of government enthusiasm for them and this increased the unevenness of their implementation.

Given all of these problems, how was Zambia able to achieve modest growth in the non-copper sector since the mid-1990s? Is the growth trend sustainable? Recently, the service sector has been the main engine of growth of the Zambian economy. More specifically, the financial sector, retail and wholesale, and real estate have driven much of the non-copper sector's growth. Growth in the financial sector has come about as a result of the financial institutions and services. Growth in real estate has been a result of privatization, the Land Law of 1995, and the flight to non-financial assets because of the loss of confidence in local banks. It is interesting to note that despite the fact that the 1995 Land Law did little to solve the significant problems associated with property rights in Zambia, the little that it did accomplish had a big impact. Getting property rights and/or control rights straightened out in Zambia has the potential to spur significant growth. Privatization has opened up the wholesale and retail sub-sector to privately owned outlets, which are able to reach all of Zambia and offer a much wider variety of consumer goods than previously available. Informal sector trading has also grown tremendously as a result of import liberalization. Many of Zambia's urban poor were forced to participate in informal sector activities as a result of shrinking formal sector employment and the absence of a social safety net. While informal sector activities have not, on balance, been able to lower the incidence of urban poverty, they have contributed to the decreasing depth and severity of that poverty. Given the increasing incidence of urban poverty, it is important that Zambia develop a well-targeted social safety net.

Although the recent growth of the non-mining sector is encouraging, its sustainability and thus that of overall growth is unclear. The growth in financial services is a good sign and indicates that this sector may continue to grow. On the other hand, it is clear that Zambia cannot count on the continuation of the strong recent growth. In order to achieve sustainable pro-poor growth the government will have to promote employment creation through the further diversification of the formal economy and a strengthening of the productive capacity of the informal sector.

To generate sustainable pro-poor growth Zambia must, among other things, develop non-traditional labor-intensive exports. Since, after copper, Zambia's comparative advantage lies in agriculture, promotion of that sector and the labor-intensive, export-oriented agro-processing industries will need to be an important component of pro-poor policy. It is critical, therefore, that Zambia develop a sound agricultural sector policy that is able to guide this sector's growth. Such a policy should get the prices (especially of credit and maize) and incentives right, while recognizing the importance of investing in key public goods such as rural marketing, extension services, and infrastructure.

ASIA AND THE NEAR EAST

Egypt

Over the last decade, Egypt has been transitioning from a state-led, inward-oriented economic system to an outward-oriented market system in which the private sector plays a dominant role. The first years of economic reform (1991-1993) were characterized by economic stagnation. Afterward, a relatively healthy growth rate resumed. Critics of the economic reform process argued that such reforms would have a negative impact on the poor. Available evidence suggests the contrary: the incidence of poverty between 1990-1991 and 1999-2000 actually decreased from 19 percent to 17 percent.

Reductions in poverty in the 1990s resulted largely from employment creation in the non-tradable service sector. Revenues from oil, which represented well over 40 percent of merchandise exports, stimulated employment creation in this sector and also resulted in employment opportunities in the Persian Gulf states for unskilled Egyptian labor. Labor migration, in turn, generated remittances that financed increased demand in the economy. Indeed, remittances averaged more than $3 billion in the 1990s, representing more than one quarter of Egypt's total exports of goods and services. In addition to these foreign sources of income, aid (which averaged nearly 20 percent of central government expenditures in the 1990s) helped finance Egypt's deficit on current account. Finally, receipts from tourism, another sector linked to volatile global forces, represented more than 20 percent of total exports in the 1990s.The rapid growth of the Egyptian economy, at least in the 1990s, largely stems from these four sources of income.

Egypt's dependence on these sources of income leaves the country vulnerable to unpredictable and volatile global forces. In addition, the proceeds from these sources of income have been used to finance consumption rather than investments in productive assets. Remittances have demonstrated substantial volatility over the last three decades and since 1989 there is evidence of a secular decline. To compound the issue there is a correlation between oil revenue and remittances: a booming oil market creates employment opportunities for Egyptian labor in the region and vice versa. While a country such as Egypt cannot afford to turn away from these potentially more volatile sources of income and employment, its domestic policy should aim at: 1) channeling whatever income the country derives from these sources toward investments in productive assets so even short- or medium-term income produces long-term benefits for the country; and 2) diversifying its economy so that it develops other substantial sources of income and foreign exchange that are not as potentially volatile.

Cross-country evidence suggests that an important way to achieve sustainable growth and poverty reduction in labor-abundant countries such as Egypt is by promoting a pattern of growth that emphasizes labor-intensive production for export and import substitution. This study shows that exchange rate management is key to export promotion; job creation; and, ultimately, poverty reduction. This is because Dutch Disease in Egypt has resulted in weakened competitiveness of these sectors in export markets and in competing with imports.

This is problematic because the non-oil tradable sectors are more labor intensive than the oil sector. The upshot is that the overvalued exchange rate has dramatically limited the growth of labor-intensive sectors. Although Egypt achieved poverty reduction despite flat merchandise exports, achieving sustainable poverty reduction despite flat or declining remittances will require that the country significantly expand its exports of labor-intensive goods. Sound exchange rate management is an important tool that can aid in achieving expanded exports.

In addition to shedding light on the relationship among growth, poverty, exports, and exchange rate management, the case of Egypt demonstrates the importance of recognizing and dealing with issues of political economy that inevitably emerge in the process of reform. Because the Government of Egypt was highly cognizant of the potential political opposition to both privatization and tenancy law reform, it appeased potential opponents. In the case of privatization, it provided financial incentives for workers to retire or resign, provided a three-year guarantee against dismissal, and controlled the speed of privatization. The government's actions in this regard were largely responsible for jumpstarting the previously stalled process. In the case of tenancy reform, the government provided reclaimed land to farmers who were negatively affected. Thus, the government contributed greatly to the acceptance of the reform.

Although international financial institutions have pressured Egypt to increase the flexibility of its notoriously rigid labor market, labor market reform has not occurred. This is in part because this is not a high priority for most domestic businesses. Although de jure labor legislation in Egypt is rigid, in reality domestic firms have developed mechanisms by which to largely avoid compliance. Labor legislation is more of a problem for international firms because they have a higher profile and thus are an easy target for inspectors. Also, these firms have not developed mechanisms that allow them to effectively avoid compliance. With more flexible labor legislation, Egypt would be a more attractive destination for badly needed foreign direct investment. Inadequate investment, both domestic and foreign, is a major obstacle to increased employment for unskilled workers. Every reform that contributes to increasing investment is therefore desirable, but labor market reform may not be as central in Egypt as is often assumed.

Reform in the agriculture sector has had a positive impact on the poor because it has generated a significant number of jobs in rural areas, where poverty is highest. The case of liberalization of rice, which positively affected nearly half of all rural households, illustrates the poverty-reducing potential of such reforms. Prior to economic reform, all stages of rice production and processing, from farmers to consumers, were controlled by the government. By 1991, the government eliminated most restrictions. The response to the liberalization of the rice sector was immediate and huge: the area planted to rice expanded by about 45 percent between 1990 and 1997 (most of the increase came from an expansion in total cultivated area and more intensive use of existing land); there was a 30 percent increase in the number of jobs created, resulting from more intensive agricultural production and private investments in milling and trading; and private sector, small-scale, low-technology mills began successfully competing against the remaining public sector mills. Private trading of rice also appreciably increased employment in the rice sector, including domestic trading and exports. Indeed, nearly 4,000 annual jobs (of the approximately 57,000 jobs created annually in the rice sector) were generated in milling and trading because of economic reforms in the sector. Other positive effects of liberalization of rice are as follows: farmers received 20 percent more for their rice, increasing their total revenue by approximately 80 percent; and the price of rice to consumers declined and exports of rice increased. Ultimately, rice liberalization resulted in substantial employment generation, but it also raised farmers' incomes and increased the welfare of rural and urban consumers.

In terms of the economy as a whole, the absolute employment and production effects of reform in rice were not large. But reforms had similar, although less dramatic, effects on other agricultural crops. Reforms in the agricultural sector during the 1990s generally improved the environment for private sector investment and agricultural production. This has been the basis for the employment growth that has occurred in the sector and has contributed to a reduction in poverty in Egypt since the mid-1990s. Evidence from the agricultural sector confirms that getting the prices right and letting private incentives work led to increased economic activity at all steps in the production-processing-consumption chain. The liberalization permitted private sector investors to invest in new equipment and new mills and to hire new employees.

The Egyptian government has not developed a national strategy to reduce poverty. As a result of the legacy of earlier populist policies, the government does possess a sophisticated social protection system that is highly inefficient and transfers most benefits to the better-off rather than to the poor. Some programs, notably bread subsidies, have had a positive impact on the poor through the introduction of self-targeting to reduce leakage.

Egypt's experience with asset transfer in the Mubarak Project has been disappointing. Poor program design, implementation, and supporting services make it difficult, if not impossible, for the targeted beneficiaries to earn a living. This project has demonstrated that transfers must be de jure and de facto if the beneficiaries are to have a chance of success. Without a title, it is impossible for the beneficiaries to obtain credit for inputs and ultimately to make needed investments. Finally, human capital development, whether in the form of education or training, is key to ensuring that Egypt is successful in its pursuit of a labor-intensive growth strategy and, ultimately, that poverty reduction in Egypt is sustainable.

Indonesia

Indonesia provides rich lessons on poverty reduction. During the first 15 years after the country's independence, poverty increased, but during the subsequent 30 years, it was reduced from about 60 percent to 15 percent, perhaps the fastest decline among populous countries. The Monetary Crisis of the late 1990s, however, had a severe impact on the country's poor. Poverty was affected by the rate of per capita growth and its labor intensity, and by the rate of inflation. Real incomes of the poor stagnated as a result of accelerating inflation from 1972 to 1976, from 1989 through 1991, and again, sharply, in 1998. During this roughly 30-year period, inflation averaged 14.5 percent per year, high by some standards, but did not seem to slow growth or affect poverty.

Macropolicy, Growth, and Poverty

Growth and labor intensity after independence were largely determined by macroeconomic policy, especially by management of the exchange rate. The decline in per capita income from independence until 1967 was the result of a thoroughly distorted economy, with perverse incentives. Indonesia was comparable to Eastern Europe in the extent to which government owned and controlled the economy. But central control was far more difficult because of its size, diversity, weak governance, and poor infrastructure. A grossly overvalued currency led to capital flight, widespread smuggling of exports and imports, a sharp drop in government revenue, and a decline in production of tradable goods. The period ended with hyperinflation, inability to service rising foreign debt, and civil strife.

The consequences for the poor were disastrous. While per capita income declined 10 percent to 15 percent over 15 years or so, the income of the poor declined by roughly half, despite their unprecedented political and trade union power. One factor in the decline was a 35-percent increase in the labor force while demand for labor stagnated. Second, following the Russian model, growth was more capital-intensive than warranted by Indonesia's factor endowment. Third was the acceleration of inflation up to 600 percent per year when Indonesia could no longer finance rice imports to make up for declining output. Fourth, resources were controlled by the military, the senior bureaucracy, and the politicians and their cronies, who were better able to protect their share of a declining income than were workers and landless laborers.

Growth of 5 percent per capita for the next 30 years (1967 to 1997) quadrupled average per capita income and increased the income of the poor comparably. During an initial period (1967 to 1971), Indonesia was set on the path to rapid growth by structural reforms that achieved expansionary stabilization. Monetary restraint and expanding supplies of goods and services controlled inflation. Greater reliance on market incentives, most notably a realistic exchange rate, and additional foreign aid, achieved this unusual feat.

The poor benefited disproportionately from rapid growth: a 50-percent increase in per capita income was accompanied by a doubling of the income of the poor, because growth was not only rapid but also was based on labor-intensive rice agriculture, supported by labor-intensive rehabilitation of the rural infrastructure. The oil boom helped, by financing labor-intensive public works. Slowing inflation from 600 percent to zero was the final element in the rapid increase in the income of the poor.

Indonesia, unlike most major oil exporters, dealt successfully with the Dutch Disease that resulted from two oil windfalls. The first windfall was used to fund the development of infrastructure; the second went partly to labor-intensive construction of schools and the hiring of teachers to achieve universal primary education. It also allowed government to support a complex system of open and disguised subsidies to keep parts of industry and agriculture viable. These interventions were often inefficient and distorted incentives, led to corruption and ill-gotten rents, and slowed growth, but they kept agriculture and manufacturing growing during the oil booms by raising the real effective exchange rate. The oil booms therefore did not harm the poor by undermining the labor-intensive tradable goods sectors or by fueling inflation.

With the end of the oil boom, the inefficiencies of government-fostered distortions and an increasingly uncompetitive exchange rate could no longer be supported. Indonesia again adjusted, however, with a new set of reforms. These included a massive devaluation as the centerpiece, lower tariffs, a temporary stabilization of the rice price, and liberalization of foreign private investment and imports. The result was very rapid growth of labor-intensive manufactured exports.

The poor again benefited. With the devaluation partly compensated for, inflation did not increase rapidly. The reforms that made Indonesia competitive in the world market especially helped labor-intensive, footloose industries. Demand for labor in industry therefore rose rapidly. Construction, trade, and services also grew, with per capita income rising at 5.5 percent a year. With inflation controlled and demand for labor strong, the income of the poor increased more rapidly than before the reforms.

Over the 30 years of rapid growth, different sectors drove the demand for unskilled labor. Agriculture, especially rice, was dominant until 1972 and important until 1987. Manufacturing became significant by 1972 and played the dominant role from 1987 on. Construction always had a smaller role, but its collapse was nonetheless important in transmitting the Monetary Crisis to the poor. Labor-intensive public works also were a major source of demand for labor during several periods.

The Asian Monetary Crisis hit Indonesia harder than other countries, as it was aggravated by structural factors. Distortions had been allowed to worsen as the economy boomed. As a crisis of confidence swept in from Thailand, a large inflow of capital turned into a large outflow. The turnaround was equal to 25 percent to 30 percent of GDP, enough to cause a crisis in any country. Corruption, inequality, and authoritarian rule were less tolerable when the majority was no longer prospering. Widespread rioting worsened the economic situation, which further angered the population.

Per capita income fell by some 15 percent, but expenditures and incomes among the poor fell by more than double that, as inflation in food prices exceeded 100 percent, and the demand for labor in the construction industry collapsed and declined in manufacturing. About five million workers crowded into work- and income-sharing activities, mainly in agriculture, or were added to the unemployed, putting pressure on wages throughout the economy. Recovery was also slower than in other crisis-hit countries. Private net capital flows continued to drain at least $10 billion a year from the economy. Vast debts had to be written off, and most banks remained in precarious condition. Political uncertainty, labor strife, widespread corruption, and a largely dysfunctional justice system remain facts of life in Indonesia. Add to that terrorism, which became a major factor in 2001.

That Indonesia nevertheless recovered quickly is in substantial part due to the flexibility of its economy. The exchange rate was allowed to perform its equilibrating function via incentives to exports strong enough to overcome the risk and uncertainty that plagued the economy. Rapidly rising exports of cash crops and some manufactures kept hundreds of thousands employed who might otherwise have been added to the ranks of workers who had lost their jobs and fueled riots and ethnic strife. The labor market was another element of flexibility: wages adjusted downward in real terms with remarkable speed. Workers moved from the collapsing construction sector to rural jobs with equally remarkable speed. The result of this flexibility was the brutal decline in real wages, but flexibility also helped revive the economy and kept poverty from deepening.

By 2002, per capita income in Indonesia was still 8.5 percent below where it had been in 1997. There is conflicting evidence on poverty. Poverty incidence, expenditure, and nutrition data all suggest poverty is down to near pre–Monetary Crisis levels or better, but wage and employment data imply that the poor are still significantly worse off than they were before the crisis and that there has been little improvement since 2000. Significant further improvement requires acceleration in the rate of growth, which has always been the main hope of the poor in achieving higher living standards.

Another important development has been increasing regional disparities with respect to poverty. Areas exporting labor-intensive agricultural products have boomed as the depreciation of the currency has made their exports more profitable. Their increased demand for labor has increased real wages in these regions by 30 percent over 2000. Surplus rice farmers have also done well as a tariff has pushed up the price of rice. The handful of workers who still have jobs in the organized sectors have also benefited; their real wages have increased by 50 percent since 2000, pushed by effective, rising minimum wages. Agricultural workers outside the booming areas, however, have suffered; their real wages have declined, as 15 percent more workers have moved into agriculture while inflation has pushed up the cost of living, partly because of protection. With the poor in some areas better off and in others worse off, differential policies and programs may be needed.

Indonesia's Programs for the Poor

Indonesia was at the forefront in successful programs for the poor. Its labor-intensive infrastructure development programs were sufficiently large and effective to have a measurable effect on real wages and, therefore, poverty. Because they provided work to many of the poorest in the off-season, during drought or other periods when jobs were hard to find, they helped maintain wages when they would otherwise have been lowest and prevented a good deal of distress. The programs provided work to a significant 10 percent of the total labor force in some years. They also speeded growth by constructing the local roads, irrigation works, and schools crucial to agricultural and rural development. Their success was due to:

- Self-targeting, by setting wage rates so low that they attracted only the poor;
- Decentralization of project selection and implementation to local governments or committees to reduce long delays, ignorance of local conditions, and inflexibility;
- National criteria for project selection;
- Publicity for funds allocated and goals set; and

- An independent inspection system to reduce waste, corruption, and diversion of benefits to the elite.

Indonesia has perhaps the largest successful program for microcredit. While the program has been highly successful in providing credit, however, it has not made a clearly significant contribution to poverty reduction and has not served as a significant safety net. Its success, rather, has come as a result of four main design features:

- Self-targeting was achieved primarily by charging interest to cover costs and yield a profit. This limited the size of loans and achieved a repayment rate exceeding 95 percent. The program was thus unattractive to large borrowers but still cheap enough for those whose alternative is the moneylender. It also made the programs self-financing.

- Credit was combined with savings-deposit facilities. A safe and readily accessible institution to hold savings and temporarily excess funds is important to rural families and businesses and improves the functioning of the rural economy. It also spreads the costs of providing credit and ensures a ready source of rural finance.

- The microcredit and savings programs were run on commercial lines, with incentives for staff to search for efficiencies in collecting as well as extending loans and expanding deposits.

- All decisions on microcredit were delegated to small local offices, which were held accountable for ensuring performance, reducing costs, and speeding decisions.

Sri Lanka

The analysis in this paper supports the following propositions, drawing on the experience of Sir Lanka to derive lessons for other countries:

It is possible to transfer enough income from richer to poorer to significantly improve the income/consumption of the poor. Sri Lanka's subsidies for food, mostly rice, and other transfers exceeded 6 percent of GDP in come years and at a minimum were 1 percent of GDP. Sixty percent of transfers reached the poorest 40 percent, raising their income by about 4 percent at least and by a quarter at most. For the poorest 20 percent the impact was more massive.

Large transfers were facilitated initially by the ease in taxing the concentrated incomes in the plantation sector. But it as a strongly egalitarian ethos that was crucial to political support. High incomes for the plantations in the 1950s- primarily going to non-voting foreign owners, managers and worker- and the ease of taxing plantation exports facilitated funding transfers initially. But fundamental was the support of both major parties for a massive welfare system until 1977.

Funding the Sri Lankan Welfare State slowed growth, but it was only one of three major factors. Rigidities and inefficiencies of government operation and control were probably more important before 1977 and continue to be significant after 1977. Insurgencies in the South were a smaller factor. The riots of 1983, followed by Civil War, and terrorism slowed growth massively. Defense expenditures exceeded welfare costs in the 1990s. The civil strife cost Sri Lanka about 2 percent of growth through lower investments and greater defense expenditures, while the Welfare State cost at most 1 percent. It is therefore oversimplified to conclude that a growth-only oriented strategy as in Korea is better for the poor than the equity-oriented strategy of Sri Lanka simply because one grew more rapidly than the other.

A shift (in 1977) from massive government intervention in the economy to a more growth- and market-oriented approach increased the rate of growth by a third; but income distribution became less equal and the share of the poor in total income declined.

With a higher rate of growth after 1977 the income of the poor grew more slowly than that of the non-poor because of other factors that affect it:

- Differences in sectoral growth rates and in their labor intensity. Rapid growth benefited the poor only if it resulted in increased demand for unskilled labor. That depended on growth in:
  - Rice Agriculture, which grew slowly after 1977;
  - Labor intensive construction. Construction grew rapidly initially, but used mostly machinery and little labor. It then grew slowly until the 1990s;
  - Labor intensive export industries, mostly garments, which grew rapidly, but from a very small base. Continued growth of this sector benefited the poor after it reached a reasonable size from the mid-'80's to the mid-'90s; and
  - Tourism, which grew only fitfully after the 1983 riots.

- The acceleration of inflation, since wages tended to lag price changes as inflation accelerated. Rapid inflation was caused by exchange rate depreciation and other reforms.

- Migration helped the poor from 1977 on, when reforms permitted and encouraged it. Nearly half of the addition to the labor force went abroad rather than exerting downward pressure on wages, a major factor in higher wages. Migration was concentrated in 3 periods, and so were its benefits. A second benefit, remittances, was of increasing importance, contributing 20 percent of export earnings recently.

- Sri Lanka was rare in achieving transfers from rich to poor that significantly increased the income of the poor through food subsidies and other targeted programs. Although not well targeted, they were so massive that the poor still benefited when subsidies increased. But the poor were hurt when, as part of the reforms of 1978, subsidies to the poor declined by 2.5 percent of GDP.

- The decline of public spending on Education and Health from over 7 percent in the early 1960s to less than 5 percent on was another factor reducing the benefits to the poor of the rapid growth following the reforms of 1977.

Offset in part by rising migration and tourism, stagnation in the income of the poor after the reforms of 1978 then was partly due to:

- Slow growth of labor intensive rice agriculture and of labor intensive construction, and the small impact on employment of rising garment exports;
- Acceleration of inflation; and
- Decline in Subsidies.

Offset in party by declining tourism from 1982, the more rapid growth in the income of the poor from the mid/late 1980s to the mid-1990s was partly due to:

- Employment created by garment exports, by then of significant size;
- Increasing migration; and
- Small increase in subsidies (an increase of over 1 percent of GDP to the poor).

Sri Lanka also was unusual in that poverty of female-headed households was no greater than for male-headed ones because poor women benefited from the rapid growth of employment in two sectors that are often spurned: garment exports and migration as maids. They provided employment to poor unskilled women and raised the wages for all women in the labor market from the mid-1980s to the mid-1990s.

The large transfer programs were inefficient and wasteful because they were poorly targeted. In 1978 the provision of more food stamps in poorer Districts and community selection of recipients achieved modest progress. But the program had elements of patronage and increasingly was subject to political influence and ethnic bias. The targeted programs also were not easily adaptable to SSN Social Safety Nets needs and they did not develop much infrastructure. Targeting could be substantially improved, which would increase the benefits to the poor by about a third, by:

- Ending or revamping the programs that are now regressive: fertilizer and credit subsidies;
- Greater use of geographic targeting and restoring local determination of eligibility;
- Making good subsidies self-targeting; and/or
- Starting a self-targeting, labor intensive public works program.

Such a package can also serve as an SSN and will generate additional infrastructure investment. However, it would require a significant political change to move from an entitlement program, which requires little from eligible beneficiaries, to a program where payment ahs a real work-requirement.

There are great regional differences in poverty despite the fact that Sri Lanka is a compact, homogeneous and relatively small country. Targeted transfers could help reduce these differences if targeting were made more efficient.

EUROPE

Ukraine

The transition process in Ukraine has been very painful, involving a sharp economic collapse, a significant increase in inequality, and hence a major rise in poverty. After a full decade of stagnation, growth returned from 2000 to 2002 and hopes have risen that the country has turned the corner.

On the eve of the country's independence, prospects for successful transition to a market economy seemed bright because of Ukraine's strong industrial and agricultural resource bas combined with a highly educated population. Despite these outwardly favorable conditions, however, Ukraine has been one of the poorest performers among the countries in the process of transition way from the former central planning system. This result is blamed on a combination of a sluggish reform process, negative exogenous shocks, and a high level of corruption. An intractable political setting in which there has been strong opposition to the transition from powerful groups has contributed directly and indirectly to the slowness, the lack of coherence, and the corruption associated with the process.

The depth of the post-reform economic decline remains a matter of debate because official figures on the performance of the economy are misleading and much depends on the inevitably imprecise estimates of the changing size of the unofficial (that is, underground or unregistered) economy. Any discussion of what has gone wrong and what has gone right must begin with an attempt to sort out the question of what has happened to the economy, to income levels, to inequality, and to poverty.

In the initial period of independence, massive shortages appeared when the state regulated process at artificially low levels; when process were liberalized in 1992, prices took off into hyperinflation. It took some time to being inflation under control, and then economy shrank sharply during this process. The unofficial sector expanded rapidly, as far as can be judged, so true gross domestic product fell less (probably 35-45 percent) then the official figures indicate (60 percent). Since 2000, the economy has rebounded, with growth of about 20 percent through 2002, according to official figures.

There was a large net increase in inequality over the 1990s. This contributed, along with the considerable fall in average income, to a dramatic increase in poverty. The precise record on the evolution of poverty during the 1990s remains ambiguous, pending further in-depth analysis and attempts to reconcile the various sources of information. Over the recent growth period, the data point to nearly constant consumption distribution and hence falling poverty incidence, suggesting that growth has been at least modestly pro-poor.

A lack of governance spawned a slow and in many ways ineffective reform process in Ukraine. An underlying cause has been the division of political power among reformers, anti-reform Communists, and rent-seeking opportunists. This division has contributed to an erratic reform process and to weak implementation. It is unclear whether a sequencing of reforms could have been designed in such a way as to prevent the extreme levels of corruption that have emerged. Another deterrent to rapid progress toward reform is the institutional inertia of the former command economy, which leads to the maintenance of many policies that are counterproductive in the context of a market economy, including a dense network of regulations and an oversized group of bureaucrats in charge of them.

The Ukrainian system of social safety nets has been modestly successful in alleviating poverty but at the same time seriously inefficient, in terms of the degree of leakage to the non-poor through lack or poor targeting and in terms of internal inefficiency in program delivery.

The objective of moving from a large-scale state and collective farm system (complemented by small household plots) to a system of individual family farms has made only modest progress, both because of strong opposition from some quarters (the Communist and opportunistic groups) and because, institutionally, the distance is long from the one system to the other. The process runs the risk of creating something closer to a Latin American style latifundia-minifundia system of land concentration than a more egalitarian family farm system. The closer it comes to the former, the more anti-poor will the agricultural evolution have been.

The nonagricultural SME sector is expected to play an important role in transition economies such as Ukraine. This role if similar to that sought in many other developing countries, but the benefits from a rapid growth of a healthy SME sector are likely to be greater in these transition economies than in most market-oriented developing countries. At the same time, the impediments to such healthy growth are more numerous and more severe. The challenge of SME development in Ukraine is parallel to that of small agriculture: moving away from a command economy built on large enterprises by encouraging new entrepreneurs and developing the markets and other elements of the support system that make the SME sector flourish. SMEs currently account for a majority of non-agricultural employment, and their share has been rising.

There is an important debate about the source of the recovery since 1999. Some observers credit the last set of reforms (in 1999-2000); others, the good crops; and others, the return of some positive inertia after the economy finally hit bottom. The most persuasive view, we believe, is that the accidental devaluation of the hyrvnia relative to other currencies than the Russian ruble (accidental in that it was the result of Russia’s financial crisis in 1998) provided a major and general stimulus to the production of tradables (both exports and import competing goods). This stimulus was complemented by a substantial underutilization of capacity.

While the dearth of relatively accurate data has not prevented our concluding that Ukraine suffered a traumatic economic collapse during the 1990s and that poverty rose sharply, failure to quickly rectify the remaining data problems will have more serious costs in the future as it becomes important to know exactly how well given policy choices are working. The national accounts figures remain weak, partly as a result of the need to shift from central-planning concepts to market concepts, partly because of the continuing importance of the hard-to-measure informal sector, and partly as a result of the need to build up the relevant human capital to maintain the information system. Figures relating to income and consumption inequality and to poverty also remain problematic, though the institution in 1999 of systematic household surveys means that the key step has been taken. Now it is a matter of gradually improving the quality of the data collected and the feed-back between analysts and data collectors. Much progress has been made but a considerable distance has yet to be covered.

LATIN AMERICA

Brazil

Brazil's record of poverty reduction in the 1990s is impressive. Despite very slow growth, it has reduced extreme poverty by 13 million people and cut poverty by almost a quarter. Three factors were especially important contributors to this performance. The first was controlling inflation. The experience of Brazil since 1980 provides strong evidence that inflation hurts the poor. Rising inflation coincided with a sharp increase in both poverty and inequality after 1987 and the end of inflation in mid 1994 coincided with a 25 percent reduction in poverty.

Complementary to the relationship between poverty and inflation is an apparent relationship between poverty and the minimum wage. Brazil provides fairly strong evidence that, under some circumstances, raising the minimum wage can reduce poverty. The real value of the minimum wage was increased sharply after inflation was controlled in 1994 and that was followed almost immediately by a big reduction in poverty. It is not possible to say whether this sequence of events is due to the link between the minimum wage and wages for the unskilled in the formal and informal sector or whether it is because the benefits in many targeted safety net programs in Brazil are tied to the minimum wage. It is quite clear, however, that in Brazil the minimum wage is an important policy instrument in poverty reduction. There are two caveats here: first, the increase in the real minimum wage has to be sustainable. It cannot simply lead to an increase in other wages and prices. Second, the wage has to be at a level where increasing it does not push a significant number of workers out of the formal sector. Both of those conditions appear to have been met in Brazil in 1994-95.

The second factor responsible for reducing poverty was the non-contributory rural pension scheme implemented in the early 1990s. That program now spends about 1.2 percent of GDP and has had a big impact on poverty, particularly rural poverty. This program must be one of the main reasons why poverty rates fell in Brazil between 1990 and 1993 despite hyperinflation and falling per capita income. Brazil's experience with the non-contributory rural pension scheme shows that if targeted safety net programs are large enough they can have significant impacts on poverty.

A large number of other targeted programs, which together amounted to approximately one percent of GDP, were also developed in the 1990s. The most important of these were two safety net programs and pensions for the aged and disabled, both of which were linked to the minimum wage. While no one has estimated the impact of these programs on poverty, the fact that most of them were developed or expanded after 1995, a period when poverty was falling despite various macroeconomic crises and recession, suggests that they must have had a positive impact.

A cursory examination of social spending and the accompanying rising interest rates and falling investment seems to suggest that social spending may be hurting growth. Brazil is now spending over 20 percent of GDP on social programs alone. This represents 2.7 percent more than it spent in 1990. Even though the government has raised tax rates, social spending, the loss of inflation tax revenue and rising interest costs have increased the government deficit, soaked up private saving and crowded out investment. Overall, social spending increases are partly to blame for the current fiscal disequilibrium. But, for the most part, targeted social spending is not the problem. Spending on contributory pensions (8.5 percent of GDP) and interest (4.2 percent of GDP) on the debt is. Brazil has a pressing need to control the cost of formal sector pensions and to reduce the interest cost of the government debt. If there is crowding out taking place, formal sector pension programs are more the cause of it than the poverty-targeted programs. The targeted programs have had a major positive impact on poverty at a cost of less than 2.5 percent of GDP.

Despite the progress on poverty that Brazil has made in the last decade, there are still a very large number of poor people in the country. To reduce poverty further, the most important single action the government could take would be to find a way to reach a higher and more sustainable growth rate. We estimate that each percentage point increase in the growth of income per capita will reduce the number of poor by at least 250,000 persons per year while at the same time helping to alleviate both the employment and fiscal problems facing the country.

Beyond attaining higher growth, a number of things would help to make growth more favorable to the poor. Most of them depend on the specific characteristics of the poor population in Brazil. Since 70 percent of the indigent and 55 percent of the poor live in the North and Northeast, it is clear that special attention has to be paid to this region, particularly its rural component. Programs should be centered on poverty-targeted investments that will help the poor and increase the growth rate at the same time. Given Brazil’s fiscal problem, the Northeast will have to grow its way out of poverty, rather than temporarily solve poverty through transfers. It can do this through investments in rural infrastructure and other activities that crowd in private investment. This should increase the growth rate of the region and provide employment that will, in turn, increase the income of the poor in the short run and raise their productivity in the long run.

Even more money and attention must be paid to education and health. Much has been accomplished in the 1990s, but Brazil and particularly the Northeast has one of the lowest completion and retention rates in the region. Some of the money saved by a reform of the pension system should be devoted to education, particularly primary and secondary education.

Finally, given the skill level of the labor force and the high level of unemployment, priority should be given to investment projects such as roads, land reclamation, buildings and irrigation all of which require a lot of unskilled labor in their construction. The government should also make sure that its policies do not harm small-scale agriculture because it, like construction, is a big user of unskilled labor.

Peru

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.

ANNEX 5

REPORTS ON THE ENCLOSED CD-ROM

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- *Pro-Poor Growth: A Guide to Policies and Programs*

- *Issues Papers, Volume I: Health, HIV/AIDS, and Privatization:*

  - "Health Issues," by James C. Knowles
  - "HIV/AIDS' Impact on Pro-Poor Economic Growth," by Joan C. Parker
  - "Privatization and the Poor: Issues and Evidence," by Leroy P. Jones

- *Issues Papers, Volume II: Conflict and Post-Conflict Recovery, the Environment, and Gender:*

  - "Conflict, Poverty, Inequality and Economic Growth," by David Pottebaum
  - "Gender and Pro-Poor Growth," by Catherine Dolan
  - "Pro-Poor Growth and the Environment," by Robert Repetto and Federico S. Fische

- *Poverty Reduction Strategy Papers: A Preliminary Analysis of the Process and Outputs*

- *Poverty-Problem Country Typologies*

- *Pro-Poor Economic Growth: A Review of Recent Literature*

- Pro-Poor Growth Country Case Studies:

  - *Reducing Poverty in Brazil: Lessons Learned and Challenges for the Future*, by Samuel A. Morley

  - *An Examination of Poverty Reduction in Egypt: Contributing Factors, Sustainability, and Lessons*, by Samira Salem and Jane Gleason

  - *Poverty During Economic Decline, Spectacular Growth and Crisis: The Case of Indonesia*, by Gustav F. Papanek

  - *The Persistence of Poverty in Peru: Possible Answers, Their Limits, and Their Implications for Latin America*, by John Sheahan

  - *Growth and Poverty in Sri Lanka: From Controls to Market*, by Gustav F. Papanek

  - *Reconstruction and Poverty Alleviation in Uganda: 1987-2001*, by John R. Harris

   - *Economic Collapse, Poverty, and Inequality During Ukraine's Difficult Transition*, by Albert Berry and Karin Schelzig
   - *An Examination of the Changing Patterns of Growth and Poverty in Zambia, 1991-2000*, by Samira Salem

- Pro-Poor Growth Sector Studies:
   - *Agriculture and Pro-Poor Growth*, by C. Peter Timmer
   - *Educational Sector Study: Pro-Poor Economic Growth Effects of Policies and Activities*, by Jere R. Behrman
   - *Finance and Pro-Poor Growth*, by Albert Berry

- *Selection Criteria for Pro-Poor Economic Growth Policies*

The goal of the USAID-funded Pro-Poor Growth Research Studies is to identify and disseminate policies, reforms, and activities that 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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