

# POOR POVERTY

THE IMPOVERISHMENT OF ANALYSIS, MEASUREMENT AND POLICIES  
EDITED BY JOMO KWAME SUNDARAM AND ANIS CHOWDHURY



UNITED NATIONS



B L O O M S B U R Y

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**The Impoverishment of Analysis,  
Measurement and Policies**

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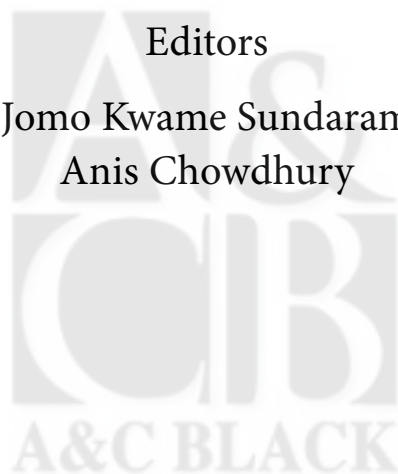


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Editors

Jomo Kwame Sundaram  
Anis Chowdhury



B L O O M S B U R Y   A C A D E M I C

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This volume responds to continuing popular interest in poverty – including its meaning, measurement, causes and elimination. This book seeks to advance our understanding of this subject by critically considering the current conventional wisdom on many dimensions of poverty. The chapters in this volume are mainly abridged and revised versions of these background papers. DESA is grateful to the authors for first preparing and then revising these papers for publication.

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# Introduction

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JOMO KWAME SUNDARAM  
ANIS CHOWDHURY

The successful counterrevolution against development economics (Toye 1987) that began in the 1970s and culminated in the 1980s with the ascendance of the Washington Consensus (e.g. see Kapur, Lewis and Webb 1997; Williamson 1990), significantly transformed the discourse on economic development. The counterrevolution later appropriated the cause of poverty reduction and invoked it to justify its own liberalization reforms involving macroeconomic stabilization (for an alternative perspective, see Stiglitz, *et al.* 2006) as well as microeconomic market liberalization reforms associated with structural adjustment.

Within this framework, poverty reduction became an outcome of economic growth without much attention to the structural causes of poverty such as inequality of opportunities and assets (or initial conditions), and of the distributional consequences of growth. While economic liberalization and stabilization reforms were expected to unleash rapid growth, social policy was reduced to 'band-aid' social safety net type solutions to take care of those falling between the cracks of generally rising welfare levels as well as victims of temporary setbacks such as cyclical downturns and job losses due to catastrophic events. In the name of poverty reduction, aid has been increasingly directed towards compensating for reduced social spending and provisioning.

However, as is now well-known, the major consequences of the reforms have been slower growth rates as well as greater inequality (United Nations 2005; Jomo with Baudot 2007). Imposing the strict policy prescriptions of the Washington Consensus, often through aid conditionalities, has significantly constrained policy space, undermining equitable and sustainable national development strategies. Failure to ignite sustainable growth, and loss of government revenues due to liberalization and tax competition have also reduced developing countries' fiscal space. This reduction of policy and fiscal space has greatly undermined sustainable and equitable development of many developing countries, especially in the face of 'external shocks', with dire consequences for poverty and destitution.

In an effort to achieve effective state and governance reform, developing countries were encouraged to privatize and down-size their public sectors. This public sector reform agenda significantly reduced the capacity and capabilities of the state, effectively denying the important role that states had historically played in developing economies. And ‘even where governments have done a good job in the past’, it was argued, ‘they will not be able to adapt to the demands of a globalizing world economy’ (World Development Report, 1997: 1). Thus, in scores of countries, state capacity was seriously undermined, and they were forced to liberalize and globalize on unequal and debilitating terms. As a result, these countries were caught in vicious cycles of poverty and underdevelopment leading to social violence, crime, corruption and instability, all of which undermine state capacity to support development.

Such policy advice and loan conditionality have been challenged by the Growth Commission,<sup>1</sup> which notes that ‘no generic formula exists. Each country has specific characteristics and historical experiences that must be reflected in its growth strategy’ (p. 2). It is worth highlighting another key observation of the Growth Commission, ‘In recent decades governments were advised to “stabilize, privatize and liberalize”. There is merit in what lies behind this injunction – governments should not try to do too much, replacing markets or closing the economy off from the rest of the world. But we believe this prescription defines the role of government too narrowly. Just because governments are sometimes clumsy and sometimes errant, does not mean they should be written out of the script. On the contrary, as the economy grows and develops, active, pragmatic governments have crucial roles to play’ (p. 6).

The varied outcomes of the 1990s led authors in the World Bank to emphasize the need for economic policies and policy advice to be country-specific and institution-sensitive.<sup>2</sup> The global financial and economic crisis of 2008–2009—the worst since the Great Depression of the 1930s—has prompted a rethinking of macroeconomic policies even within the international financial institutions which had earlier promoted the Washington Consensus.<sup>3</sup> There is now a greater recognition of the need for counter-cyclical macroeconomic policies and capital account management.

For example, the World Bank observes, ‘Capital restrictions might be unavoidable as a last resort to prevent or mitigate the crisis effects. ... Capital controls might need to be imposed as a last resort to help mitigate a financial crisis and stabilize macroeconomic developments’.<sup>4</sup> A similar position has also been advocated in a staff position note of the International Monetary Fund.<sup>5</sup>

## THE POVERTY CHALLENGE

The chapters in this volume are based on papers solicited as background materials for the preparation of *The Poverty Challenge: Report of the World Social Situation 2009*. The chapters consider various dimensions of poverty in rather different ways, but together, they constitute important challenges to recent ways of thinking about and addressing poverty. While they do not constitute a coherent whole, they should raise important questions of poverty analysis and poverty reduction policies and practices in recent decades.

By almost any standards, including the 1994 United Nations Conference on Population and Development, the 1995 Copenhagen Social Summit and the 2000 Millennium Declaration, there has been modest, but insufficient progress globally towards the reduction of poverty and deprivation over the last three decades. If we leave out the spectacular reduction of poverty in China and other parts of East Asia over this period, the record for the rest of the world is even more dismal. Wide ranging deficits in the human condition remain endemic and ubiquitous in most poor countries, but also in many rich countries with respect to certain vulnerable groups.

What is particularly disturbing is that these disappointing outcomes in many crucial dimensions have persisted despite several growth spurts at a global level, and even sustained growth in several large developing countries. This shameful failure has continued despite pious declarations and professed commitments by the global community to the worthy goals of the Millennium Declaration. This situation is likely to be set for further disappointment by the ongoing financial and economic crisis. While the timing of economic recovery, and its sustainability, continue to be the subject of much debate, it is certain that job recovery and the advancement of decent work conditions will lag behind considerably, with severe adverse consequences for real incomes and living conditions.

Why and how has this predicament come about? Several key messages come through loud and clear from the discussion and analysis in *The Poverty Challenge*:

- The dominant mainstream perspectives on poverty and deprivation have fundamental limitations, contributing to considerable distortion and misunderstanding, in turn leading to poor and ineffectual policy prescriptions.
- Without sustained growth in per capita output and significant job creation, policies seeking to help the poor will not succeed. The growth process

also needs to be more stable by maintaining a consistently counter-cyclical macroeconomic stance and developing greater economic security including a better capacity to deal with exogenous shocks. Also crucial for the development process are measures reducing inequality and promoting structural change.

- Policies favoured by the dominant mainstream thinking within the international financial institutions and among donors since the 1980s have generally failed to address these issues. Instead, the major consequences of their policy prescriptions have been slower growth rates (notwithstanding the recent half decade from 2003 to 2007/8) as well as greater inequality in most countries (global inequality measures among countries are more ambiguous because of the spectacular growth of China during this period).
- Policy prescriptions, often imposed through aid conditionality, have significantly constrained developing countries' policy space. Failure to ignite growth spur, and the loss of revenues through various liberalization programmes also have reduced developing countries' fiscal space. This constriction of policy and fiscal space has greatly damaged developing countries, especially in the face of external shocks or natural disasters, with dire consequences for poverty and destitution.
- Generally speaking, those economies which have done well in terms of both growth and poverty reduction over the last three decades have adopted pragmatic, heterodox economic development policies. While invoking the mantra of the market, they have generally managed the market to encourage private investments, especially in desired economic activities, e.g. those creating many employment opportunities, directly or indirectly, as well as those offering increasing returns to scale.
- While growth is a necessary condition for poverty reduction, the creation of decent employment opportunities is also important. Furthermore, the extension of social provisioning and protection should be integral to the development and poverty reduction strategies. But such redistributive policies cannot be sustainable without ensuring growth and thus raising average incomes as well as the fiscal basis for social spending.
- With the inability of microeconomic economic liberalization reforms and macroeconomic stabilization programmes to ignite rapid and sustained growth, social policies have involved increasing targeting practices, ostensibly to achieve greater cost effectiveness. However, universal social policies have generally proved to be much more effective as well as politically sustainable. Social policies aimed at targeting the poor, or the 'poorest of

the poor', have often proved to be expensive and politically unsustainable, while missing out many of the deserving poor.

- Special programmes, such as microfinance, formalization of land titles or governance reforms are unlikely to yield significant results when the growth process falters or becomes inequitable.

## THIS VOLUME

The opening chapter by Erik Reinert draws an important parallel between the inadequacy of much contemporary thinking about poverty as well as its amelioration and the poverty of recent understanding of macrofinancial stability, which contributed to the ongoing global financial and economic crisis. He criticizes the 'terrible simplifications' which have been the common roots of the poor understanding and analyses of financial crises and persistent poverty in economic theory. Similar mechanisms in economic thinking have contributed to these parallel failures. He focuses attention on what Hyman Minsky called 'destabilizing stability', referring to long periods of stability leading to increasing vulnerability and eventually financial crisis. Such long periods of economic progress in the core countries have led to increasingly abstract and irrelevant economic theories. Reinert argues that a similar failure in economic theorizing in the first half of the 19th century led to turning points—referred to by him as the '1848 Moment'—towards more relevant economic theories. He also identifies key variables that need to be reintroduced into economic theory for poor countries to develop the type of productive structures that make possible sustained economic development to eliminate poverty.

Lance Taylor elaborates on the relationships among economic growth, development policy and employment creation, which is generally agreed to be the only sustainable basis for mass poverty reduction, in Chapter 2. He argues that without sustained growth in per capita output and significant job creation, policies seeking to directly help the poor will not succeed. Taylor argues that such policies will not succeed in reducing poverty in a sustainable manner without sustained growth in per capita output and significant job creation, and instead proposes growth-promoting policies. The growth process will also be more stable and sustainable by ensuring a consistently counter-cyclical macroeconomic stance, especially in dealing with exogenous shocks from abroad. Taylor also suggests how macroeconomic prices, such as exchange and interest rates, can be better managed to support developmental objectives. Like Reinert, he too advocates pursuing industrial



and trade policies to promote desirable economic activities especially those involving increasing returns to scale. Also, measures promoting appropriate developmentally proactive financial development are crucial for the development process. Particularly for the poorest countries, making more productive use of foreign aid can be crucial due to severe resource constraints. The over-riding policy concern should be ensuring that national economies have sufficient policy space to achieve sustained growth and structural change.

Mushtaq Khan examines the interrelations among governance, economic growth and poverty reduction in chapter three. Recognizing that poverty reduction is influenced by economic growth, income distribution as well as distribution changes, he suggests that governance can impact both economic growth and distribution. The hegemonic or mainstream 'market-enhancing' governance paradigm seeks to enhance market efficiency through 'good governance' reforms, ostensibly to trigger or sustain more rapid economic growth. As structural and fiscal constraints prevent significant improvements in governance capabilities, market failures are likely to remain significant, but unlikely to be significantly reduced by governance reforms. Like the stabilization of property rights, good rule of law and significant reduction of corruption, the achievement of good governance goals requires fiscal capabilities not available in most developing countries. More recently, ostensibly 'pro-poor' good governance reforms claim to enhance the scale and efficiency of service delivery to the poor. Khan also challenges the good governance approach to enhancing economic growth more broadly. He argues that neither theory nor evidence strongly support the claim of significant poverty reduction through advancing the good governance agenda. Instead, he suggests that alternative governance approaches for addressing poverty are more likely to accelerate poverty reduction. Developing countries, therefore, need to focus on alternative governance capabilities that will enable them to better address market failures.

Sanjay Reddy exposes the methodological inadequacies of poverty measurement in chapter four, by critically reviewing recent global poverty estimates by the World Bank. He shows that the 2008 revision of the World Bank's global poverty estimates based on a new \$1.25 (2005 purchasing power parity or PPP) poverty line has only underscored their unreliability and lack of significance. He critically reviews various aspects of the Bank's approach and makes several recommendations for better poverty measurement. Reddy argues that the Bank's poverty line is not only flawed, but also not very useful, if not problematic for policy purposes. He argues that various aspects of the Bank's approach can hardly be justified. Much less weight should therefore be given to the Bank's poverty estimates in monitoring the first Millennium

Development Goal (MDG) to reduce poverty and hunger by half from 1990 to 2015. He argues that the conceptual and methodological problems require adopting an altogether different method requiring international coordination by the key institutions involved. He argues that an acceptable alternative already exists, but will require global institutional coordination.

Jayati Ghosh reviews recent trends in poverty reduction in China and India in chapter five before suggesting some key policy implications. She shows that what has mattered critically for poverty reduction is the nature of the growth process, rather than economic growth *per se*. Growing inequalities can prevent the benefits of growth from reaching the poor. Ghosh also argues that appropriate structural change accompanying growth can generate sufficient opportunities for productive non-agricultural employment, thus reducing rural poverty. Fiscal capacity has to be assured in order to finance the provision of basic needs and essential social services. Like Reinert and Taylor, she emphasizes that government mediation of market processes and of global economic integration has been crucial for determining economic and social outcomes.

Aneel Karnani's chapter six argues that the movement promoting neoliberal reforms to reduce poverty has found strong expression in the 'bottom of the pyramid' (BoP) approach in recent years. The BoP approach presumes that the poor are all 'resilient and creative entrepreneurs and value-conscious consumers'. This romanticized view of the poor harms the poor in at least two ways. First, it results in too little emphasis on legal, regulatory and social mechanisms to protect the poor who are, by and large, vulnerable to various marketing gimmicks and unable to take advantage of economies of scale in consumption. Second, it romanticizes and overemphasizes micro-credit while underemphasizing the crucial importance of large modern enterprises that can provide stable and decent employment opportunities for the poor. Besides its touching faith in market miracles, the approach underemphasizes the critical role and responsibility of the state in poverty reduction.

In chapter seven, Anis Chowdhury critically reviews the debate on the efficacy of microfinance as a universal poverty reduction tool. He argues that while microfinance has enabled some innovative management and entrepreneurial strategies, its overall impact on poverty reduction remains in doubt. He also notes some criticisms, such as the high interest rates typically charged for micro-credit, despite the high rate of implicit subsidization and the related issue of the social opportunity cost of these subsidies. Chowdhury acknowledges that microfinance plays an important role in providing finance for contingencies and in smoothing consumption. Borrowers may also benefit from the opportunity of learning-by-doing and from developing

greater self-esteem as a consequence. Furthermore, by ‘democratizing’ the credit market, the microfinance movement has not only curtailed the power of money lenders, but also constrained financial institutions’ behaviour in dealing with loan defaults by the poor. However, to make any significant dent on poverty, Chowdhury argues that the focus of public policy should be on growth-oriented, equity-enhancing programmes, such as broad-based productive employment creation.

Ruth Meinzen-Dick reviews the links between property rights and poverty reduction, including the gender distribution of property rights, in chapter eight. She also highlights the ambiguous nature of property rights, the implications of multiple claims on property, and how this complicates property rights reform. For her, poor people not only lack current income, but also lack assets with which to generate incomes today and tomorrow. For billions of rural poor and the urban poor living in informal settlements, access to land may not be legally recognized. While redressing this through legislation may provide more secure land tenure for the poor and thus reduce poverty, experience shows that this outcome is hardly assured. Policies that have not taken into account the complexity of property rights have backfired, actually reducing poor people’s security of tenure. Meinzen-Dick also explores the implications of strengthening the property rights of the poor, in particular, how understanding legal pluralism can lead to more effective policies and interventions to strengthen poor people’s control over assets.

Guy Standing argues for universal cash transfers as a way of improving economic security, especially as rapid globalization, climate change and other sources of economic insecurity are threatening livelihoods. The basic premise is that economic security depends on the ability to cope with shocks, uncertainty and hazards, and to recover from adverse developments. The chapter reviews evidence of outcomes of various non-cash transfers such as food aid or vouchers vis-à-vis various types of cash transfer schemes implemented in developing countries. In contrast to food aid and vouchers, which have distortionary effects on domestic production and consumption patterns, cash transfers are found to promote work and dignity. Cash transfers also satisfy various principles of social justice besides being more efficient and cost effective. Standing concludes that experiences with cash transfers strengthen the case for universal unconditional cash transfers as a way of ensuring basic incomes for all.

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## NOTES

- 1 Growth Commission (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*, The International Bank for Reconstruction and Development The World Bank: Washington, DC.
- 2 Nankani, Gobind T. (ed.) (2005). *Economic Growth in the 1990's: Learning from a Decade of Reform* World Bank: Washington, DC.
- 3 See Blanchard, Olivier, Giovanni Dell'Ariccia, and Paolo Mauro (2010). "Rethinking Macroeconomic Policy", *IMF Staff Position Note*, February 12, 2010, SPN/10/03. However, after reviewing IMF's agreements with 41 crisis-affected countries that include Stand-By Arrangements (SBA), Poverty Reduction and Growth Facilities (PRGF), and Exogenous Shocks Facilities (ESF), one study concluded that 31 of them contained pro-cyclical macroeconomic policies. See Mark Weisbrot, Rebecca Ray, Jake Johnston, Jose Antonio Cordero and Juan Antonio Montecino (2009). "IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-one Borrowing Countries". October, Center for Economic Policy Research, Washington, DC.
- 4 World Bank (2009). *Global Monitoring Report 2009: A Development Emergency*, (pp. 47–48).
- 5 Ostry, Jonathan D., Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi and Dennis B.S. Reinhardt (2010). "Capital Inflows: The Role of Controls", *IMF Staff Position Note*, February 19, 2010, SPN/10/04.

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# Chapter 1

## The Terrible Simplifiers: Common Origins of Financial Crises and Persistent Poverty in Economic Theory and the New ‘1848 Moment’

---

ERIK S. REINERT

*... soon or late, it is ideas, not vested interests,  
which are dangerous for good or evil.*

John Maynard Keynes, closing words of  
*The General Theory* (1936)

The United Nations recently announced that the number of chronically hungry people on the planet has exceeded the billion mark for the first time. It is extremely unlikely that any of them will ever hold a Swiss 1,000 franc banknote (worth more than 900 dollars), but if they did, they would see the portrait of a man who perceived the essence of the explanation as to why extreme poverty and extreme plenty coexist so naturally on this planet, and of the grim fate of the permanently starving—Swiss historian Jacob Burckhardt (1818–1897). Burckhardt coined the term ‘the terrible simplifiers’ to describe the demagogues who—in his dark vision of what the 20th century would bring—would play central roles in the future (Dru 2001: 230). Events amply fulfilled Burckhardt’s predictions of a cataclysmic 20th century, of the rule of terrible simplifiers, men who were Burckhardt’s colleagues at the University of Basel, Friedrich Nietzsche, called power-maniacs (*Gewaltmenschen*), and John Maynard Keynes referred to in 1936 as ‘madmen in authority’.

A key common element in persistent world poverty and in the financial and (real) economic crisis is the ‘terrible simplification’—a theoretical overshooting into irrelevant abstractions—that has taken place in economic theory after World War II. As unlikely as it may initially sound, I shall endeavour to explain in this paper how—in spite of its apparent sophistication—equilibrium economics became ‘mathematized demagoguery’ based on an extremely simplistic world view. Joseph Schumpeter’s solution to the late 19th century

Methodenstreit ('battle of methods') of economics had pointed in a very different direction, arguing that the profession needed to have theories at different levels of abstraction. According to the problem posed and the question asked, one should be able to enter the edifice of economic theory at a level of abstraction where one was likely to find an answer (Schumpeter 1908). After World War II, economics experienced the opposite development: only very abstract theory survived. In this process, the main causes of uneven development as well as the cause of financial crises were assumed away from the theoretical edifice. The financial crisis appears to have created a turning point. The July 18, 2009 edition of *The Economist*—normally a weekly that strongly supports mainstream economic theory—portrays the crisis in economic theory on its front cover with a book entitled 'Modern Economic Theory' experiencing a meltdown like an ice-cream abandoned on the beach on a hot summer's day, with the subtitle: 'Where it went wrong—and how the crisis is changing it'.

#### WHERE ECONOMICS WENT WRONG: ON ABSTRACTION VS. SIMPLIFICATION

All theories depend on abstractions. When we use the word 'leaf'—like leaves on a tree—we are making a sweeping generalization by implicitly overlooking the enormous differences that exist among various types of leaves. However, opening the theoretical box labelled 'leaf', we find that botanical science has produced a very detailed classification system for leaves: sword-shaped (*ensiformis*), lance-shaped (*lanceolata*), ovate (*ovata*), elliptic (*elliptica*), cordate (*cordata*), oblanceolate (*oblanceolata*), etc. Most people eating blackberries would be satisfied with recognizing just one species (*Rubus fruticosus*), but in my country (Norway) alone, botanists distinguish among a large number of species, for which the main distinguishing factor is the shape of the leaves (*Rubus plicatus*, *fissus*, *sulcatus*, *radula*, etc.). The apparent simplification of using the word 'leaf' is a justified abstraction, not a terrible simplification, because—in the spirit of Schumpeter (1908)—it is possible to arrive at a qualitative understanding of leaves through a taxonomy (a classification system) for leaves that exists on a multiplicity of levels, down to a level of detail that far exceeds most people's needs.

In botany, opening the very abstract box called 'leaf', we find a very complete taxonomy at different levels of abstraction. If we pry open most of the theoretical abstractions in economics, we shall find that even these static boxes are empty. Economics hardly contains any taxonomies; in fact, the

most salient feature of economics as a science is the ‘equality assumption’; the economic mainstream effectively assumes away all differences among human beings, among economic activities and among nations. One classic example of this is the concept of the ‘representative firm’, which equates the giant firm Microsoft with a twelve-year-old self-employed shoeshine boy in a Lima slum (Reinert 2007).

Assuming that qualitative differences do not exist—as does mainstream economics in key areas—is a terrible simplification that has extremely serious consequences in terms of lost human welfare. We can only understand why medical doctors make more money than truck drivers if we are willing to observe the differences between the two professions. In parallel fashion, we can only understand the difference in wealth between the United States and Africa by qualitatively understanding the huge differences in the productive structures of the two areas.

The roots of this problem are already found in Adam Smith’s *Wealth of Nations* (1776), where the author bundled all manufacturing, all agriculture and all trade—all human economic activity—into one single category: labour hours. I have previously explained how Adam Smith is at his least convincing when he tries to prove to his readers that all economic activities are alike (Reinert 1999). Building on ‘labour hours’ as the only unit of accounting, David Ricardo (1817) constructed the labour theory of value that provided the origins of international trade theory that essentially conceived of world trade as the bartering of labour hours, void of any quality, among nations. Not even the fact that some economic activities obviously are able to absorb more capital or become more mechanized than others is accounted for.<sup>1</sup>

Economic theory is cyclical, and this paper argues that crises create turning points when theory is forced to move from a very high level of abstraction—from practical irrelevance—to something more closely resembling reality, and therefore becomes more able to solve the problems facing us.

International trade theory’s prediction of equalization of wages across countries is, in my view, the key terrible simplification that causes world hunger. Not only are all qualitative differences assumed away, the production process itself is also abstracted away. Assuming away unemployment, as the World Bank traditionally does in its models, only adds another dimension to the terrible simplification on which our world economic order is based. In many countries, 80 per cent of the potentially active population are unemployed or underemployed. Assuming that fact away is a terrible simplification.

Even very simple taxonomies may have strong explanatory power. If we divide human beings into just two different categories, men and women, we can explain procreation. Similarly, as Friedrich List (1841) observed, successful



economic strategies have historically been based on the classifications found in King (1721), which have been the basis for all successful strategies of catching up. The core theoretical argument explaining this lies in an equally simple binary taxonomy found in a 1923 paper by US economist Frank Graham (see Appendix 1), arguing that a key point in the career of Nobel Laureate Paul Krugman was precisely the elimination of Graham's taxonomy.<sup>2</sup>

US historian Richard Goldthwaite shows the historical importance of the dichotomy between raw materials and manufacturing in a recent book: what is generally seen as Europe's 'commercial revolution', Goldthwaite argues, was in fact a process of import substitution—manufactured goods, that had previously been imported in the Levant, started to be produced in Europe from the 12th century onwards (Goldthwaite 2009, 6–8). I shall argue that this extremely important distinction—between raw materials subject to diminishing returns, monoculture and perfect competition on the one hand, and manufactured goods subject to increasing returns and a large division of labour on the other—was lost in the post-WW II period. Only nations that continued their industrialization strategies—like India and China, starting from the late 1940s—have been successful during the latest process of globalization. If India and China are removed from the sample, globalization is a shambles, even more so in terms of real wages than in terms of GDP per capita (because wages as a percentage of GDP have been reduced across the board).

Today's mainstream economics, I would argue, has lost not only a key feature of the Enlightenment—making order by producing classification systems (taxonomies)—but also the key feature of the Renaissance that preceded the Enlightenment: the immense creativity and innovations, in all aspects of human life, unleashed during that period. Economics lost what Nietzsche refers to as 'capital of will and spirit' (*Geist- und Willens-Kapital*). Our qualitative understanding ('verstehen' in German philosophy) was crowded out by a more mechanical form of understanding (see Drechsler 2004 for a discussion). In this way, the process of economic development became reduced to a process of adding capital to labour in a quasi-mechanical fashion, much like adding water to soluble coffee. By neglecting the differences between economic activities, economics was not able to break the core of the vicious circles that keep poor countries poor, the mutually reinforcing lack of purchasing power and lack of employment (see Kattel, Kregel and Reinert 2009).

The accuracy so admired by today's economists has been achieved at the cost of eliminating diversity, of having produced concepts that are empty boxes and of having embraced what Nobel Laureate James Buchanan (1979: 236) calls 'the equality assumption'. At the core of our world economic order lie the terrible simplifications of international trade theory. Assuming perfect information (i.e.

that all know the same) and constant returns to scale for all ranges of output for all goods (i.e. no fixed costs), and assuming that all goods are private, there is no reason why there should be any trade at all (except in raw materials, for reasons of climate and geography). In its most simple form, the theory that regulates international trade is based on assumptions that mimic conditions which would not produce any division of labour or any trade. It describes a world in which every human being would be a self-sufficient microcosm. The WTO and our world order are based on theories that are, at their very core, fairly simplistic banalities wrapped in an appearance of ‘science’.

## RECONSTRUCTING RELEVANT ECONOMICS

*I foresee that within the next ten or twenty years the now fashionable highly abstract analysis of conventional economists will lose out. Though its logical base is weak—it is founded on utterly unrealistic, poorly scrutinized, and rarely even explicitly stated assumptions—its decline will mainly be an outcome of the tremendous changes which, with crushing weight, are falling upon us*

(Gunnar Myrdal, Swedish development economist)

This quotation from Nobel Laureate Gunnar Myrdal dates from 1956. This chapter argues that Myrdal was wrong only about timing. The process he describes is happening now, because only now—with the worldwide financial crisis—is it possible to see the basic weaknesses of standard textbook economics as they relate to the financial crisis and to persistent poverty in the Third World.

In his 1952 book, *The Counterrevolution of Science: Studies in the Abuse of Reason*, Austrian economist Friedrich von Hayek (1899–1992) states that ‘never will man penetrate deeper into error than when he is continuing on a road which has led him to great success.’ Hayek pictures a process of scientific decay that grows out of the excesses that follow from the very success of a particular set of ideas. Twenty-two years later, after having shared the Nobel Prize with the same Gunnar Myrdal, we find Hayek arguing along the same lines. Had he been consulted as to whether to establish a Nobel Prize in economics, Hayek says in his Nobel dinner speech, ‘I should have decidedly advised against it.’ Hayek’s main argument against awarding a Nobel Prize in economics was that such a prize ‘would tend to accentuate the swings of scientific fashion.’ Economics differs from other sciences, Hayek notes.

Following Kuhn (1970), the idea of changes in scientific research agendas—or paradigms—became common knowledge. Science occasionally makes radical breaks. But economics is different from the hard sciences in that, through the mechanisms described by Hayek, the paradigm decays by overshooting into irrelevance (Reinert 2000), and the need for correction is perceived and carried out. But, here also, economics differs from other sciences. Once it has been understood that the world is not flat, but round, the idea of a flat earth never comes back. In economics however, the paradigmatic overshooting into excesses—as described by Hayek—brings back theoretical elements that had previously been present, but were later discarded.

The theoretical overshooting, then, is caused by making economics gradually excessively abstract, which eventually necessarily creates a counter-reaction. Economics as a science thus oscillates cyclically over time between very abstract theory, as the theory ruling from the stagflation of the 1970s until the 2008 financial crisis, and less abstract theory.

The 2008 financial crisis and the failure to eradicate poverty in the Third World are both results from the kind of overshooting—political and ideological—explained by Hayek. The financial crisis and persistent poverty, I argue, are both the result of a theory that got too abstract and became fascinated with tools and methods that failed to take into account extremely important aspects of economic reality. After the financial crisis, everyone says ‘We are all Keynesians now’. Both in the case of the financial crisis and in terms of advice to poor countries in the economic periphery, it is time to resurrect the thinking of John Maynard Keynes.

Financial crises make it clear that markets, if left to themselves without regulation, do not produce economic harmony. Harmony is the result of wise regulations. Such crises open people’s eyes to the fact that the same principles of potential market-made disharmony also apply to the markets for goods and services. Also in trade policies economic harmony is a result of wise regulations. After the 1847 financial crisis, John Stuart Mill recanted David Ricardo’s trade theory. John Maynard Keynes also tells us how he changed his mind about the same free trade theory—which, in the meantime, had come back into fashion—around the time of the 1929 crisis. Both Mill and Keynes saw that poor countries need an increasing returns sector,<sup>3</sup> i.e. an industrial sector, in order to become wealthy.

The financial crisis in 1847 triggered a dramatic shift in economics starting in 1848. ‘If you went to sleep in 1846 and woke in 1850 you would wake into a different world’ wrote an English university professor in his memoirs (Reeves 2007: 202). This paper argues that we are now facing a very similar

situation: an ‘1848 Moment’ when the economy is seen in a new light, less abstract and more firmly based on empirical observations.

#### ECONOMICS ABSTRACTED FROM PRODUCTION: THE COMMON ELEMENT IN FINANCIAL CRISES AND PERSISTENT POVERTY

What unites the failure to understand that a financial crisis was coming and persistent poverty in the Third World is an economic theory at a level of abstraction where *production* is left out, a theory where the world economy is perceived as stock markets and freight terminals. In reality, markets and trade are mere complements of an incredibly complex global system of *production*. By focusing on stock exchanges and trade, the complexities of world production have essentially been left out of economic theory. In the case of the financial crisis, the blind spot was the inability to see the separation of financial economy from the real economy of production of goods and services, and how the uncontrolled growth of the former could, in the end, destroy the latter. This separation was clear to the main economists who contributed to our understanding of financial crises in the past: Thorstein Veblen, Joseph Schumpeter and John Maynard Keynes. In the case of persistent poverty, the parallel blind spot is the unwillingness to face up to the overwhelming historical proof that middle-income and rich nations can only be built on a large division of labour in the presence of increasing returns. In both cases the core of the problem is a failure to qualitatively understand the productive sector of nations.

As we have seen, the roots of this problem go far back to when Adam Smith bundled production and trade together as ‘labour hours’ and David Ricardo—and especially his later followers—produced a theory of international trade representing the world economy by bartering labour hours. The parallel in the financial sector is that David Ricardo also forgot to create ‘money’ as a separate category. Economic theory based on such abstraction created blind spots on the collective retina of economists, and the illusion of markets guaranteeing a harmony. Economists modelled a dam: a system automatically seeking equilibrium when disturbed. The financial crisis and persistent poverty in the Third World amidst a world of plenty expose the fundamental flaws of a science based on the metaphor of equilibrium.

This illusion of guaranteed harmony has undermined the productive capacities of poor countries in the world periphery just as it has undermined world financial markets, and huge rescue operations—paralleling those in financial markets—need to be launched to rebuild the productive sectors in

poor countries. The blind spots and faulty reasoning behind the profession's misreading of both problems—financial crises and persistent poverty—are closely related. Therefore, the same economists—e.g. Keynes—who understand financial crises also understand why mainstream economics fails to correct persistent poverty in the periphery.

Several key failures of current academic economics are common to both financial crises and persistent poverty in the world periphery:

1. Not separating the sphere of money, or the financial economy (Schumpeter's *Rechenpfennige* or 'accounting units'), from the real economy of goods and services (Schumpeter's *Güterwelt*). Not distinguishing between the two spheres of the economy, neoclassical economists (as opposed to, say, traditional continental European economists) were blind to the possibility of a financial crisis. For the same reason, neoclassical development economics attempted to solve the problems of poverty by transferring capital rather than by addressing the problems of the productive sectors in poor countries.
2. Not keeping an eye on a nation's productive structure as its economic core, focusing on finance rather than on the impact of finance on the real economy. In normal times, the financial sector serves as scaffolding for the real economy. Financial crises begin when the financial sector starts making money in ways that do not help the real economy, when banks enter into loan agreements that are so risky that the borrowers are not even able to pay interest on their loans: Ponzi financing (Minsky 1990). Unsustainable financial pyramid schemes fill financial markets with 'toxic assets', liquidity is withdrawn, and financial crisis occurs.
3. Not recognizing that a functioning capitalism requires investments to be made in potentially profitable ventures, not in Ponzi schemes. From this point of view, subprime lending and, to a large extent, lending to the Third World, were both Ponzi schemes: loans made to people and nations that could not reasonably be expected to have a cash-flow that would even cover the interest on loans they were given (Kregel 2004). Here, Kregel makes an extremely important point: The Myrdalian 'perverse backwashes'—that more funds tend to flow from poor to rich countries rather than the other way around (Myrdal 1956)—can be explained by the same Minsky mechanisms that explain the current financial crisis. The current lack of industrial policy in poor countries makes it impossible to generate sufficient industrial rents to make investments profitable (see Cimoli, Dosi and Stiglitz [eds] 2009).

The financial crisis showed us that Hyman Minsky was right in describing and predicting ‘financial fragility’. Something apparently very solid, like the global financial system, in reality proved to be very fragile. As the crisis develops we are experiencing other economic fragilities as well: poor countries are increasingly experiencing ‘wage fragility’ in productive systems (as an example public sector wages in Latvia were cut by 25 per cent in early 2009). If vicious circles of decreasing wages, decreasing demand and decreasing tax bases are allowed to continue as they presently do in the periphery, we may experience increased ‘livelihood fragility’ there: physical survival may be increasingly threatened. In wealthy countries the influx of poor labour is already starting to produce ‘technological fragility’: a much lower cost of labour eliminates the incentives for expensive mechanization and we may experience a degree of ‘primitivization’<sup>4</sup> of developed economies.

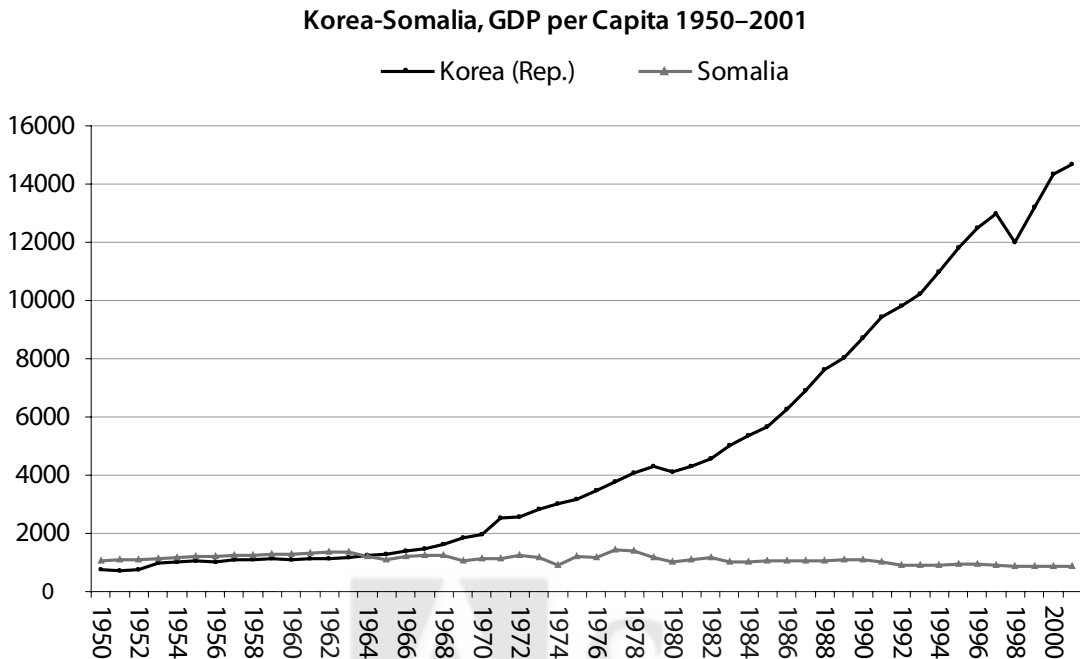
Carlota Perez (2002) argues that major booms and busts always result from projecting the real success of fundamental technological breakthroughs on to other projects which lack this characteristic. When US Leather wished to be valued as US Steel, and when Parmalat tried to do to milk or Enron to energy what Bill Gates had done to computing, and markets were willing to believe the story, the road to fraud was short.

#### THE CHALLENGE: RELEARNING THE ART OF CREATING MIDDLE-INCOME COUNTRIES

Until 1964, the Republic of Korea was poorer than Somalia. Figure 1.1 shows how Korea started an impressive growth spurt while Somalia got gradually poorer. This happened because Korea consciously changed its comparative advantage in international trade from products subject to diminishing returns (raw materials) to increasing returns (manufactured goods and advanced services). In this way, Korea escaped from the poverty trap explained in Frank Graham’s classic 1923 article ‘Some Aspects of Protection Further Considered’ (see Appendix 1).

Why are there so few middle-income countries? Why do countries tend to cluster in two convergence groups, developed and ‘underdeveloped’? Why is it so difficult to create national economies that are half way between Somalia and Korea on Figure 1.1?

Figure 1.1:  
**Comparing economic development in Somalia and Korea**



Source: Reinert, Amaizo and Kattel (2009)

This paper argues that our inability to create middle-income countries is a result of ‘terrible simplifications’ resulting from destabilizing stability, as described by Minsky, from ‘theoretical overshooting’ in Hayek’s sense. The policy recommendations resulting from this theoretical overshooting have made the creation of new middle-income countries virtually impossible. A middle-income nation has an increasing returns (industrial) sector which, for a while, is not yet competitive on world markets. Opening to free trade was supposed to even out world incomes. The WTO’s first Director-General, Renato Ruggieri, declared that we should unleash ‘the borderless economy’s potential to equalise relations among countries and regions’. Instead, this process ended up killing the incipient industrial sectors in poor countries, lowering real wages. The belief that the market, left to itself, guarantees harmony was at the core of the Washington Consensus ideology of the International Monetary Fund (IMF) and the World Bank.

#### THE FAILURE OF NEOLIBERAL DEVELOPMENT POLICY

Until the mid-1970s, development economics was based on the notion that a middle-income country is a country with the same type of economic structure—a large manufacturing sector—as a rich country. It was understood that for a variety of reasons—among them market size, technological sophistication, relatively high price of capital relative to labour, etc.—the industrial sector

of a poor country would need a lot of time before it would be strong enough to face competition from wealthier countries. This period of ‘infant industry protection’—as John Stuart Mill called it—is comparable to the many years amazon.com operated its business with great losses. Slowly industrializing a nation represents the same kind of trade-off between present costs and greater returns (e.g. wages) in the future. In the meantime the poor country would earn scarce foreign exchange from the export of commodities. For developing countries, customs duties tend to provide a large share of government revenue, and because ports were relatively easy to control, even weak governments could easily secure this revenue (e.g. compared to a value added tax).

As already alluded to, if China and India are separated from the rest of the developing world the development record over the last 35 years has been poor in most developing countries. China and India have based their national development on continuing their industrialization efforts<sup>5</sup> started around 1950 (Nayyar 2007). In no way can these countries be considered showcases of the neoliberal policies propagated by the Washington Consensus. On the contrary, they followed the policy advice of Friedrich List (1841) that industrialized Continental Europe and the United States: industrializing and then slowly ‘opening up’ borders. China and India may have allowed too little competition for too long, and may have opened up late, but these are small mistakes compared to the policy errors of the Washington Consensus responsible for the deindustrialization of so many developing countries in the periphery.

The term *creative destruction*, inspired by Joseph Schumpeter, has grown increasingly popular, and is sometimes used to justify all kinds of changes.<sup>6</sup> However, destruction and creativity may take place in different parts of the globe, as when the textile mills of Manchester replaced the weavers of Bengal during the first Industrial Revolution. This paper argues that trade liberalization divided the Third World into two groups: (1) those—like India and China—that pursued industrialization for more than 50 years and benefited from access to the world market, and (2) those countries where industrialization was too weak to survive, the synergies of industrialization were put in reverse, and the economies deindustrialized and thus became *primitivized* (Reinert 2007: Chapter 5).

Early economic writers repeated again and again that all wealthy nations had one important thing in common: a large number of different manufacturing industries all subject to increasing returns (Reinert 2009a). It has been common knowledge since the 1400s that a wealthy city was created by a ‘common weal’, a *ben commune*. The first author to pinpoint increasing returns and diversified manufacturing as the key to wealth creation was the Italian economist, Antonio Serra, who in 1613 explained why Venice, virtually void of natural resources, was so rich, while his own Naples, rich in natural resources, was



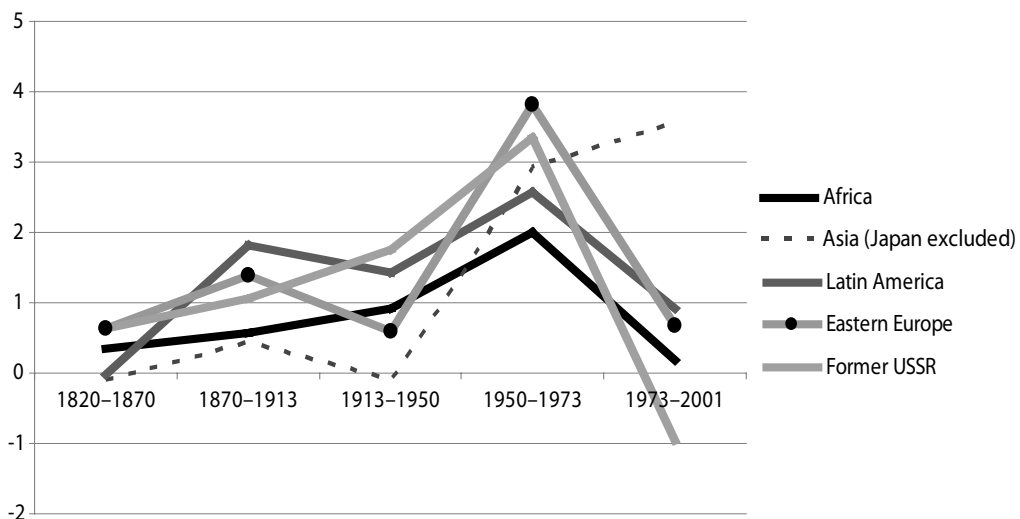
so poor. Without increasing returns, there was no dynamic capitalism, a very limited division of labour, and no high wages. From this perspective, colonialism involves a technology policy preventing increasing returns activities from being established in the colonies (Reinert 2007).

Serra's 1613 treatise argued that increasing returns was at the core of the wealth-producing mechanisms in each of these many different activities. Maximizing the division of labour was at the core of any policy of 'good government' (S. Reinert 2010). A large number of activities subject to increasing returns was the key to national wealth, and—most importantly—middle-income nations were those where the same type of activities and the same large division of labour were present, but in a system slightly less efficient than in those of the world leaders. A slightly less efficient manufacturing and service nation was much wealthier than the most efficient producers of raw materials (subject to diminishing returns). To make a comparison appealing to the readers' intuition: it is much better to be a mediocre lawyer than to be the world's most efficient cotton-picker. This is the principle upon which all successful industrial policy has been built from Henry VII came to power in England in 1485 until the post-WW II Marshall Plan in Europe. It has been articulated by classical development economics, but undermined by the Washington Consensus. The rest of this section shows the mechanisms with which the Washington Consensus policies have *primitivized* the periphery.

Figure 1.2 shows how rates of economic development improved and peaked at the height of classical development economics in the mid-1970s. Only East Asia, with its recent tradition of industrial policy, has managed to keep up the positive trend.

Figure 1.2:

**Growth rate of GDP per capita of selected world regions; regional average in selected periods between 1820 and 2001; annual average compound growth rate**



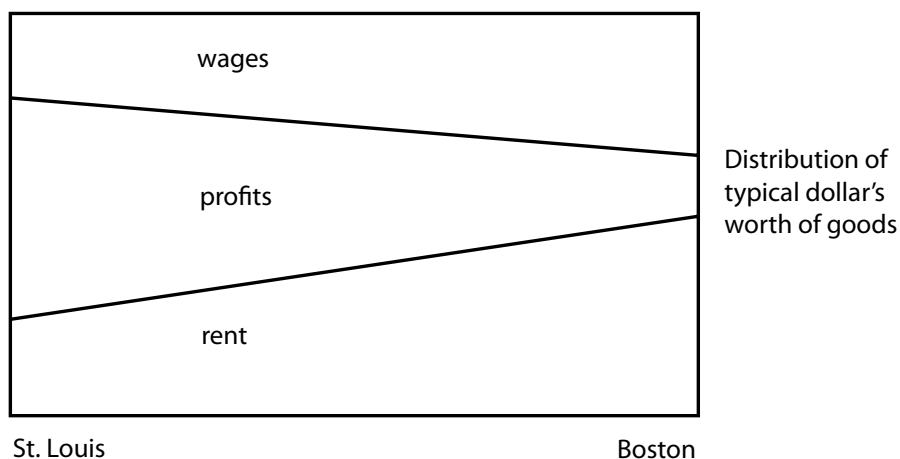
Source: Kattel, Kregel and Reinert (2009). Original data from Maddison (2003)

Figure 1.2 shows the dismal performance of neoliberal development policies that came into effect starting in the late 1970s, when debt crises in the Third World forced Third World countries to open up abruptly. Deindustrialization was the price paid for being saved by the IMF and the World Bank.<sup>7</sup>

### INCREASING RETURNS AND SYNERGIES: THEIR CREATION AND THEIR DESTRUCTION

In many ways, the United States can be seen as the prototype successful developmental state. After US independence, the Continental European understanding of development as synergies among a large number of increasing returns industries was retrieved from European literature and rediscovered by US economists. These economists insisted that the United States, in spite of its abundance of natural resources and obvious comparative advantage in agriculture, would grow poor without manufacturing industry (Hamilton 1791; Raymond 1820; M. Carey 1822). Later, along the same lines of reasoning, Henry Carey (1793–1879) insisted that trading too much with Britain would preclude the United States from enjoying the bounties of future technological change. Carey also devised what he called a ‘commodity map’, which illustrates how the presence of a manufacturing sector changes the way income is distributed within a nation. Carey’s map, which could also have been called a ‘development synergy’ map, is an illustration of the centuries-old observation of the effects of a manufacturing sector. Today, the map can be used to explain the mechanisms by which Washington Consensus policies increased poverty in the world periphery.

Figure 1.3:  
Henry Carey’s ‘commodity map’ (1858)



(Modified from Carey (1858a), iii, p. 187)

Source: Perelman (2002: 90)

Figure 1.3 represents the breakdown of a typical dollar's worth of goods, i.e. a proxy for what we would call output or GDP. The height of the graph represents 100 per cent of GDP. Carey shows how different the composition of GDP was in the developed East compared to the undeveloped West of the United States at the time; the graph indicates how the composition of output changes as one moves gradually from Boston to St. Louis—from right to left in the figure—or vice versa. Economic development—increasing the division of labour and manufacturing—is represented by moving east from St. Louis, Missouri towards Boston. Poverty and backwardness grow as one moves west from Boston to St. Louis. St. Louis thus represents the situation in the undeveloped world or periphery today. Here, raw materials—e.g. cotton or cattle—are produced; land is abundant and cheap, labour is unskilled and cheap, tasks are simple and the division of labour is limited. Under such conditions, Carey says, profits take up a large share of the GDP.

The East, Boston, represents today's developed world with a large division of labour that adds a lot of value to a raw materials base. In the East, in contrast to the underdeveloped West, a multitude of workers combine their efforts within a complex social division of labour to work raw materials into ever more sophisticated products. More skills are required, increasing returns create higher profits and higher barriers to entry. Here, wages and rents form a much larger portion of the value of products, while profits shrink to a smaller percentage of GDP.

If a nation should move over time from Boston to St. Louis, that means undoing the synergies of development, reversing the critical mass that creates wealth, in a sense travelling from capitalism back in time towards something resembling feudalism. This more than 150 year old graph shows how Washington Consensus policies that started in the late 1970s have produced the same regressive effect as Henry Carey claims moving from Boston to St. Louis would have done in 1858: wages as a percentage of GDP sank slowly, while rents and profits—the FIRE sector: finance, insurance and real estate—grew correspondingly.

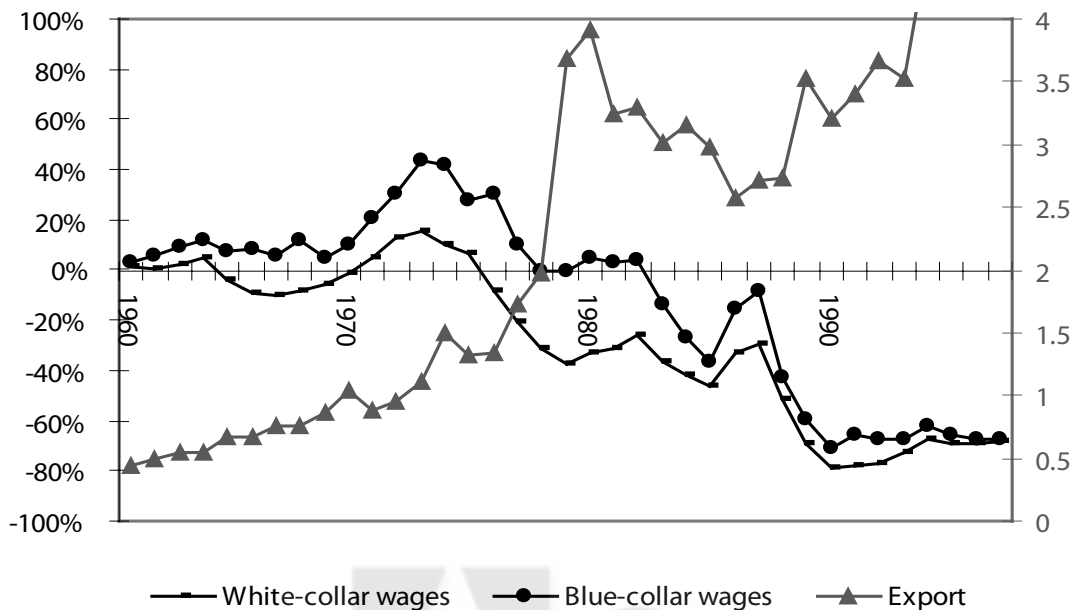
'Market failure' is a term often used when actual developments fail to behave the way economic theory would predict. Cimoli, Dosi and Stiglitz (2009) acknowledge that 'market failure' is not a useful way to approach the problem of poverty. In fact, from a Schumpeterian angle, what we generally refer to as 'development' is, in fact, a 'market failure' compared to the standard neoclassical model assuming perfect competition and diminishing returns. What all developed countries have in common is a large increasing returns sector that has created huge barriers to entry, imperfect competition,

and a ‘rent’ that has been divided among capitalists (high profits), labour (high wages) and the government sector (larger tax base) (Reinert 2009a). In this section, we shall see how the policies of the Washington institutions led to the destruction of these industrial rents, and to huge falls in real wages. The shock therapies of the Washington institutions—instant free trade and ‘structural adjustments’—sent poor countries, whose industrial sectors were not yet competitive on the world market, ‘from Boston to St. Louis’ in Carey’s scheme.

Looking at the example of Peru since 1950, waves of industrialization and deindustrialization have been associated with fluctuations in living standards. The standard of living of the population has been inversely related to the weight of the primary sector in the total economy. During the period 1950–1997, a one percentage point decrease in manufacturing as a share of GDP led to a fall in white-collar wages by 5.4 per cent, and a fall in blue-collar wages by 7.5 per cent. Conversely, when manufacturing increased by one percentage point in total GDP, white-collar and blue-collar real wages increased by 10.6 and 15.5 per cent respectively (Roca and Simabuko 2004). Going back to Carey’s map, we can conclude that every time manufacturing increased as a percentage of GDP, this corresponding to ‘moving east’ on the Carey map: wages went up. Every time the manufacturing sector shrank, it corresponded to ‘moving west’ on the Carey map: wages went down.

Figure 1.4 shows how real wages in Peru peaked in the mid-1970s when the country did everything ‘wrong’ according to the Washington Consensus. Peruvian industry was kept up by high tariffs and represented a ‘bad’ form of protection. Industrialization was ‘artificial’, but the wages, roads, schools and hospitals created by this industrialization were all real. It is also important to see how exports took off and made the country look very successful while real wages were plummeting at the same time. The Washington Consensus shock therapy hit Peru on two fronts simultaneously—with deindustrialization plus downsizing the public sector. By killing off the two sectors with strong union power—one private, one public—the whole national wage level collapsed. This was accompanied by a rapid fall in the terms of trade (Reinert 2007: Figure 15).

Figure 1.4:  
Industrialization, deindustrialization and real wages in Peru

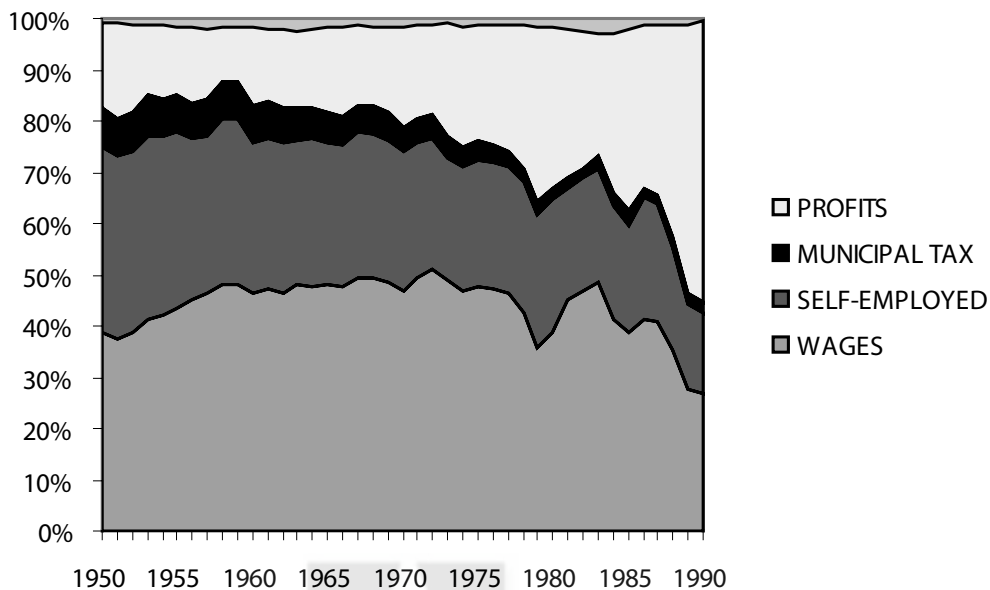


Source: Reinert (2007)

Peruvian wage levels fell much faster than GDP, as the composition of Peruvian GDP changed. Figure 1.5 shows how dramatic this change was. At the height of industrialization in Peru in 1972, wages amounted to 51.2 per cent of GDP and the income of the self-employed was 26.5 per cent, a total of 77.7 per cent of GDP. Figure 1.5 shows how wages, salaries and the income of the self-employed shrank rapidly as the country prematurely opened up to free trade. In 1990, the last year the Peruvian central bank provided a breakdown of GDP in this way, the share of wages in GDP had been almost halved to 26.5 per cent, and the share of the income of the self-employed had fallen to 15.9 per cent. In total, the wages, salaries and the income of the self-employed as a share of GDP had shrunk by 45 per cent—from 77.7 to 42.4 per cent of GDP—as a result of Washington Consensus policies from the mid-1970s to 1990. The ‘national industrial rent’ had been destroyed, with devastating consequences for real wages that had been more than halved in real terms.

Rapid trade liberalization led to rapidly falling real wages, worsening income distribution and primitivization of the economy back to a more feudal structure, corresponding to a voyage from developed Boston to underdeveloped St. Louis in Henry Carey’s model. This underscores why a poor nation is much better off with a relatively inefficient manufacturing sector than with no manufacturing sector at all. I have argued that successful economic policy has been based on a ‘cult of manufacturing’ before introducing free trade since the late 1400s (Reinert 2007). Occasionally—as just before the French Revolution (1789), just before

Figure 1.5:  
Peru: Deindustrialization and falling wages as a share of GDP, 1950–1990



Legend, from top, profits, pre-dial (tax), income of the self-employed, wages.

Source: Banco Central de Reserva del Perú. Breakdown of GDP by source has not been published after 1990

1848, and after the stagflation of the 1970s—theoretical ‘overshooting’ based on excessively abstract models has led to this understanding being abandoned. In all three cases the result has been seriously worsening social conditions for the poor. Just before the French Revolution free trade in grain had led to a shortage of bread in Paris. The Storming of the Bastille, marking the start of the Revolution, was triggered when news of the dismissal of the last anti-physiocrat (anti-free trader) Jacques Necker as Minister of Finance reached Paris. Just as in 1848—which will be discussed in the concluding section of the paper—ill-timed free trade was seen as a source of human suffering. Free trade may come into conflict with the right to food, as French economist Simon Linguet (1736–1794) argued.

John Maynard Keynes was not only right about financial crises, but his advice to poor peripheral countries, in the early 1930s, should be given to poor countries today, adapted to the current technological context of course. Following the first period of globalization, Keynes recommended a certain measure of deglobalization in order to promote peace:

*I sympathize, therefore, with those who would minimize, rather than with those who would maximize, economic entanglement among nations. Ideas, knowledge, science, hospitality, travel—these are the things which should of their nature be international. But let goods be*

*homespun whenever it is reasonably and conveniently possible, and, above all, let finance be primarily national. Yet, at the same time, those who seek to disembarrass a country of its entanglements should be very slow and wary. It should not be a matter of tearing up roots but of slowly training a plant to grow in a different direction.*

*For these strong reasons, therefore, I am inclined to the belief that, after the transition is accomplished, a greater measure of national self-sufficiency and economic isolation among countries than existed in 1914 may tend to serve the cause of peace, rather than otherwise. At any rate, the age of economic internationalism was not particularly successful in avoiding war; and if its friends retort, that the imperfection of its success never gave it a fair chance, it is reasonable to point out that a greater success is scarcely probable in the coming years (Keynes 1933 in Keynes 1972).*

In the same paper, Keynes tells us how his view of free trade changed:

*I was brought up, like most Englishmen, to respect free trade not only as an economic doctrine which a rational and instructed person could not doubt, but almost as a part of the moral law. I regarded ordinary departures from it as being at the same time an imbecility and an outrage. I thought England's unshakable free trade convictions, maintained for nearly a hundred years, to be both the explanation before man and the justification before Heaven of her economic supremacy. As lately as 1923 I was writing that free trade was based on fundamental 'truths' which, stated with their due qualifications, no one can dispute who is capable of understanding the meaning of the words.*

It is my conviction that a new generation—particularly in the Third World—soon will come to look at late 20th century truths in the same way Keynes looked at those of the 19th century: 'It is astonishing what a bundle of obsolete habiliments one's mind drags round even after the centre of consciousness has been shifted'. As long as financial crises only hit the periphery, the blame could be put on the peripheral countries themselves, not on the economic system: the Asian Crisis was blamed on 'Asian values' and 'crony capitalism'. Now, when the crisis has hit the core nations, we may see a shift in the centre of consciousness as regards economic realities in the developed world. The risk is, however, that policies towards the Third World may continue to be guided by the same 'obsolete habiliments' inherited from Washington Consensus principles.

CONCLUSION: TOWARDS 'AN 1848 MOMENT'  
WHEN EMPIRICAL KNOWLEDGE MATTERS AGAIN

'You don't get dramatic change, or reform, or action unless there is a crisis', then US Treasury Secretary Henry Paulson recently said, commenting on the financial crisis (*New York Times*, December 26, 2008). Unfortunately, Upton Sinclair's assertion that 'It is difficult to get a man to understand something when his salary depends on his not understanding it' appears to apply both in the world of theory and practices. With the clear light of understanding, many economists' handling of the financial crisis suggests 'financial illiteracy' (*Financial Times*, December 24, 2008, page 1). The growing list of fragile, failing and failed states (FFFs) testifies to the fact that poor nations have long been in crisis. However, persistent, but untruthful rhetoric claiming the relative successes of China and India as a result of trade—rather than of half a century of heavy-handed industrial policy—has effectively obliterated the miserable economic performance of much of the rest of the poor world.

Financial crisis will bring reform, but the 'developmental illiteracy' that has paralleled 'financial illiteracy' also urgently needs addressing. Huge subsidies in the form of cash transfers have saved the financial cores of capitalism against their own mistakes. Now, it is time to save the true victims of the market—the world's poor—from the same type of mistakes, imposed on them by others. At the core of both problems—financial crisis and persistent poverty—is a mistaken theory claiming that markets are, by nature, harmony-creating. However, centuries of experience show that 'efficient markets' produce 'spontaneous chaos' as much as they produce 'spontaneous order'; 'destructive destruction' is perhaps as frequent an outcome as 'creative destruction'. And as Jacob Burckhardt commented to a junior colleague at the University of Basel, Friedrich Nietzsche, 'There are (or at any rate, there seem to be) absolutely destructive forces under whose hoofs no grass grows' (Burckhardt 1943: 214). Both in financial markets and international markets for goods and services, order and progress are always achieved through wise policies from a perspective that sees the market as a tool rather than as a goal.

We mentioned the French Revolution and the late 1840s as two periods when views of the market as harmony-ensuring swiftly shifted to acknowledge that markets are potentially chaos producing. However, with the theories of David Ricardo, the illusions of trade as a harmony-producing machinery came back. 1846 saw the repeal of the Corn Laws and the peak of influence of Ricardo's economic theory. A deep financial crisis in 1847 marked a turning point, followed in 1848 by revolutions in all large European countries with the exception of England and Russia.



1848 produced three important books all critical of the economic order legitimized by Ricardian economics: Karl Marx and Friedrich Engels' *Communist Manifesto* (Marx was so radical that he was forced to flee Germany for England), Bruno Hildebrand's *National Economics in the Present and in the Future* (Hildebrand was a liberal who had to flee Germany for Switzerland in order to escape the death penalty<sup>8</sup>) and John Stuart Mill's *Principles of Political Economy*. From completely different political angles, all three books attacked the mainstream economics of the day for suffering from the same weaknesses of which we accuse today's mainstream. By attempting to make economics a much more accurate science than it merits, mainstream economics has created economic disasters: both financial crisis and poverty in the periphery. All three 1848 books understood that national wealth required industrialization, recanting Ricardo's trade theory, the very same theory which at present—in its most simplistic form—provides the basis of the world economic order that locks poor nations into a comparative advantage of being poor. Table 1.1 illustrates the kind of shift in economic focus likely to result from the current '1848 Moment' precipitated by the financial crisis.

Table 1.1:

**The coming shift in economic focus: Before and After the 1848 moment**

<b>Pre-Financial Crisis Focus</b>	<b>Post-Financial Crisis Focus</b>
Capital	Technology and entrepreneurship
Financial economy	Real economy
International trade	National production
Economic models	Economic facts and their contexts
Distribute capital ('aid') to eradicate poverty	Distribute production to eradicate poverty
Perfect competition	Poverty eradication needs high wages and capital formation that only dynamic imperfect competition creates
Economics strongly ideologically biased. The Washington Consensus maintained markets are good and the state is bad	Separation of analysis and ideology, 'technocratic' analysis
Economic activities qualitatively alike	Economic activities qualitatively different
Gross national product per capita	Real wages
Economics as a science defined by the use of certain tools	Economists' toolbox extended to any relevant approach
The market as an ideological goal	The market as a tool for wealth creation

John Stuart Mill—celebrated today as an important liberal (in the European sense)—acknowledged that poor nations needed manufacturing industry and recommended ‘infant industry protection’. In a speech to Belgian workers in 1848, Karl Marx was pleased with Ricardo’s free trade theory because premature trade liberalization would create poverty and hastening revolution. Warlords in the world periphery may appreciate free trade for the same reason Marx did: premature trade liberalization locks a nation in a pre-capitalist and backward economic structure that prevents democracy. A nation without a large division of labour and a web of increasing returns’ industries is unlikely to be able to support a democratic system. Enlightenment economists and philosophers were very aware of the fact that increasing returns, industrialization and democracy go hand in hand. John Stuart Mill not only rediscovered the reasons for ‘infant industry protection’, but also understood that at the core of widespread poverty lies the curse of diminishing returns (compare Serra’s work from 1613, Graham 1923 and Reinert 1980):

*I apprehend (the elimination of this factor) to be not only an error, but the most serious one, to be found in the whole field of political economy. The question is more important and fundamental than any other; it involves the whole subject of the causes of poverty; ... and unless this one matter be thoroughly understood, it is to no purpose proceeding any further in our inquiry. (Mill 1848: 176)*

Mill also describes the collective wake-up call when an inappropriate type of theory is left behind, defining the generic ‘1848 Moment’:

*It often happens that the universal beliefs of one age of mankind—a belief from which no one was, nor without an extraordinary effort of genius and courage could at the time be free—becomes to a subsequent age so palpable an absurdity, that the only difficulty then is to imagine how such a thing can ever have appeared credible ... It looks like one of the crude fancies of childhood, instantly corrected by a word from any grown person. (Mill 1848/1987: 3)*

The one single message in this paper is that the only way to create middle-income countries is to create countries with a large division of labour in increasing returns sectors—countries with a manufacturing sector (and advanced services). Diversification away from the primary sector and the creation of employment must be given priority before free trade. This has been the basis of all successful developmental practice since the late 1400s and of development theory since 1613. At times, this principle gets suppressed by excessively abstract economic theories—at the time of the French Revolution,

in the 1840s and since the late 1970s—but empirically-based theories eventually come back, resurrected by economic crises. The nexus that always gets rediscovered is the apparently paradoxical but crucial connection between manufacturing and wealth: that building a non-agricultural sector is the best way to eradicate poverty and famine.

An English pamphlet expresses this very clearly as early as in 1690: ‘It is also remarkable, that Mechanicks prevent Famine in a Nation; this at first sight will appear a Paradox, that the multiplying of Mouths, that eat corn, whose hands sow none, should yet increase food; which matter of fact demonstrates the Truth of, notwithstanding: For whoever saw a Famine in Holland? On the Contrary, they who sow none, yet supply other parts of the World with Corn, which they effect by means of their Arts and Trade’ (A Discourse 1690, 29).

The Marshall Plan following World War II was based on this same principle. The Morgenthau Plan that had been created in order to deindustrialize Germany after World War II had proved that the absence of industry also created famine in Germany in 1945–1947, as it had done throughout European history (Reinert 2004). The Marshall Plan came into being in early 1947 as this fact was recognized, thus representing yet another ‘1848 Moment’ in the history of economic thought. The Marshall Plan was based on the exact opposite principle of the Morgenthau Plan, on the reindustrialization of Europe, and it was the most successful development plan in the history of mankind. The 1948 Havana Charter—approved by all members of the United Nations at the time—was based on the principles of John Stuart Mill and of the Marshall Plan. A blueprint for the development of peripheral economies exists in the Havana Charter, and a key factor is the timing of free trade. Policies that create and nurture increasing returns’ sectors in poor countries are needed, and discussion of how and when to turn on and off will be as heated as it has always been. When successfully promoted—as in the United States—protection carries the seed of its own destruction: having achieved a certain size and skill level, protected companies themselves seek larger markets and freer trade in order to stay competitive. History does not supply easy formulas, but at least shows us some very important principles that have been ignored far too long due to the Washington Consensus.

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## NOTES

- 1 A Heckscher-Ohlin framework introduces more factors of production, including land and capital, and indeed opens up for what is called the Rybczynski Theorem: as one factor of production (e.g. capital) grows, the output of the capital-extensive commodity (e.g. innovations-based production) grows, while the output of the labour-intensive product contracts. In other words, some nations will easily specialize in innovation-intensive (generally also increasing-returns-intensive and imperfect-competition-intensive) products with a large division of labour and get rich, while other nations will specialize in labour-intensive technological dead ends, often devoid of scale-effects and innovation potential, producing under perfect competition, diminishing returns and monoculture (this is a key point in Reinert 2007). By opening up for diversity, this model of international trade also opens up for a theory of unequal development.
- 2 For the discussion about how Krugman changed from agreeing with Lenin and the classical development economists that the increasing/diminishing returns dichotomy creates poverty traps to excluding the diminishing returns part of the argument, see DESA working paper, ST/ESA/2009/DWP/88.
- 3 Activities subject to increasing returns are those where production costs fall as the volume of production increases. These lower costs for established firms form important barriers to entry for newcomers, and produce a type of imperfect competition that forms the basis for extra income, for a 'rent', that is shared between capital (profits), workers (in the form of higher wages), and government (in the form of higher taxable income) in industrial countries. I argue that what we call 'development' to a large extent consists in establishing such 'industrial rents'. Resource-based activities, on the other hand, always have one factor of production (land, ore, etc.) limited by nature, and are therefore subject to diminishing returns. Costs cannot be lowered beyond a certain point because inputs are only available in poorer quality than the first and best resources used: lower quality land, lower grade ore, etc. The low barriers to entry for the production of raw materials lead to 'perfect competition' or 'commodity competition', and the shared national rents that can be created in increasing returns activities are impossible to create in a country where only resource-based activities are present. Later in this chapter, we see how Washington Consensus policies ruined industrial rents in poor countries, thereby lowering the real wages by more than 50 per cent in many cases (see Reinert 2004, 2007, 2009a for further discussions). The 'normal' case in economic textbooks is 'perfect competition' and 'diminishing returns'. In a sense, Washington Consensus policies succeeded in making poor countries look more like the ideals of standard textbook economics, but this made these countries much poorer than they would have been with industrial rents.
- 4 Several mechanisms of economic primitivization are introduced in Reinert (2007, Ch. 5)
- 5 Here, I am referring to their domestic industrialization policy from around 1950, not their specialization in international trade much later.
- 6 The term *creative destruction* entered economics via Friedrich Nietzsche and Werner Sombart (Hugo Reinert and Erik Reinert 2006). The financial instruments creating 'toxic assets' have added a new Schumpeterian term: 'destructive creation'.
- 7 Detailed case studies show how this process evolved in Mongolia and Peru (Reinert 2004; Roca and Simabuko 2004).
- 8 Hildebrand was a critic of Engels who argued that poverty in the 1840s was worse where there was no industry to speak of.

## APPENDIX I.

## FRANK GRAHAM'S THEORY OF UNEVEN DEVELOPMENT

## Increasing and diminishing returns in international trade: a numerical example

Stage 1.2:

**World income and its distribution before trade**

Product	Country A			Country B		
	Man-days	Output per man-day	Total	Man-days	Output per man-day	Total
Wheat	200	4	800	200	4	800
Watches	200	4	800	200	3	600

World production: 1,600 wheat + 1,400 watches. In wheat equivalents: 3,200

Country A's income in wheat equivalents: 1,714 wheat

Country B's income in wheat equivalents: 1,486 wheat

Price: 4 wheat = 3.5 watches

Stage 1.3:

**World income and its distribution after each country specializes according to its comparative advantage**

Product	Country A			Country B		
	Man-days	Output per man-day	Total	Man-days	Output per man-day	Total
Wheat	100	4.5	450	300	3.5	1050
Watches	300	4.5	1350	100	2	200

World production with trade: 1,500 wheat + 1,550 watches

In wheat equivalents: 3,271

Country A's income in wheat equivalents: 1,993 wheat

Country B's income in wheat equivalents: 1,278 wheat



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# Chapter 2

## Growth, Development Policy, Job Creation and Poverty Reduction<sup>1</sup>

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LANCE TAYLOR

Almost a decade into the 21st century, absolute poverty is still pervasive outside the industrialized world. Helping poor people in poor countries improve their levels of living is on the shortlist of key international policy goals. The air is full of ideas about how poverty should be analyzed and attacked. Although there have been some recent success stories, particularly in East Asia, the unhappy truth is that anti-poverty programmes in developing countries have quite often failed or had limited success.<sup>2</sup>

The reason for this is that these programmes did not enable poor economies to generate long-term growth of real per capita income. A useful rule of thumb is that developing and transition economies should sustain at least 2 per cent annual per capita real growth of gross domestic product or GDP. That would stop the gap separating their standards of living from the industrial world's from widening even further, and 3 per cent or more would gradually reduce it. A 2 per cent per capita growth rate can make a big dent in poverty by increasing average income by 22 per cent over 10 years and 49 per cent over 20. In addition, growth can only address poverty concerns if it generates new jobs to keep pace with a rising labour force.

Relatively few developing and transition economies have been able to mount steady growth at 2 per cent or higher for long time periods. The quarter century or so after the second oil and interest rate shocks of 1979 was particularly critical in this regard, as many developing countries started to face long-term stagnation or even regression. There was, after 2000 because of booming terms of trade from primary products and low interest rates, significant growth but with the economic crisis that began in rich countries in 2007 and spread worldwide, this interlude has probably ended.

The reasons why sustained growth has been difficult to attain lie with the linkages among economic *structure*, policy and growth. The emphasis on "structure" is essential here, as the analysis to follow is deeply embedded in a

“structuralist” tradition of development economics, which provides the best way to understand the problems that people in poor countries have to confront in trying to reshape their national economies.

Since the mid-1970s, but particularly the 1980s, and under the strong influence of the World Bank and the International Monetary Fund, there was a significant change in the overall framework for development policies, from the tradition of strong state intervention that had prevailed after the Second World War, to what came to be called the “Washington Consensus”. This orthodox framework asserts that economic liberalization—that is, letting the market take over from the state—is the answer to speeding up growth in the developing world. Orthodoxy was followed, to a greater or lesser extent, in both developing and transition economies, and they generally experienced poor growth records.

In contrast, structuralism argues that there is clearly something missing from mainstream analysis—it *omits structure and structural change*. This may sound paradoxical because the main orthodox slogan was “structural reform”, the term frequently used instead of “economic liberalization”, which is what it was meant to imply. The use of the term “structural” in these programmes is entirely different from the older usage, followed herein and explained below.

Poverty is central to this distinction. The most widely publicized anti-poverty programme today is the Millennium Development Goals (MDGs) effort sponsored by the United Nations. It calls for roughly doubling foreign aid to the poorest economies over the next 10 years. The aims are exemplary. An incomplete list ranges from halving, by 2015, the levels of extreme poverty and hunger that developing countries had in 1990, to providing universal primary education, sharply reducing infant and maternal mortality, increasing access to water and sanitation and ensuring environmental sustainability.

Almost everybody can accept these merit social goals, but there are two important caveats. First, there is a major question about whether foreign aid flows will increase from around \$100 billion per year in 2007 to the levels required to meet the MDGs. This problem is compounded by the fact that measured aid flows include “debt relief” to the poorest countries, which is not really new aid, as well as technical assistance delivered by professionals from donor countries, which may be useful, but is very costly. Such outlays are not really funds available for the recipient countries to spend on achieving the MDGs.

Secondly, the emphasis on merit social goals hides the fact that the key to reducing poverty is growth of the purchasing power of the poor. International donations, by themselves, are unlikely to bring about sustained growth in the

poorest economies. Growth, accompanied and supported by structural change, is what is needed. It makes sense to discuss briefly the reasons why before going on to outline how economic policy can be utilized in diverse structural circumstances to generate growth. Macroeconomics and finance are first addressed in a bit more detail, followed by discussions of economic structure and employment, and foreign aid. Policy alternatives are then presented.

## MACROECONOMICS AND EXTERNAL SHOCKS

Orthodox development economics places a great deal of emphasis on the supply side. For example, higher saving is supposed to transform itself into more investment and faster growth, instead of holding down aggregate demand and output or spilling over into a current account surplus. Higher levels of education are supposed to guarantee people higher incomes from better jobs, but the implicit assumption is that the jobs will be available in the first place. Very often, employment generation adequate to absorb a growing population in developing countries is not observed. When it is observed, labour productivity may be stagnant or falling, so real incomes do not rise. Why are these discouraging outcomes so common?

In reality, if there is a supply factor that plays a *central* role in developing countries, it is foreign exchange availability, rather than production capacity. An immediate implication is that external shocks, both positive and negative, crucially influence macroeconomic dynamics. Counter-cyclical macroeconomic policies are key to coping with massive external shocks, not only to smoothen the domestic impact of external demand fluctuations, but also to steer important macroeconomic prices—the exchange and interest rates, in particular—to levels that can further developmental objectives.

Avoiding exchange rate overvaluation during booms is crucial to support the structural transformation of the economies towards new export- and import-competing sectors with higher technological content, and for export and production diversification in general. In turn, maintaining growth during externally-induced crises requires both avoiding high interest rates and managing the foreign exchange constraint (the “external gap”) faced by developing countries during these periods. Stability in both exchange and interest rates is also fundamental to facilitate rapid capital accumulation.

Regrettably, pro-cyclical macroeconomic policies have become the rule, rather than the exception, in the developing world. Pro-cyclical policy responses multiply the impacts of external shocks. The net result has been exchange rate appreciation and inflationary pressures during booms and

severe recessions or outright growth collapses during crises. As discussed more fully below, liberalization policies may have helped reduce inflationary pressures, but have clearly worsened pro-cyclical responses through capital account and financial deregulation and their general disregard for the developmental objectives of exchange rate management.

Structural conditions matter in this area in at least three different ways. First, the character of developing countries as “risky borrowers” in international financial markets generates pro-cyclical variations in the availability of external finance and in pro-cyclical interest rates that are very hard to manage for developing countries, particularly when the capital account is fully liberalized.<sup>3</sup> Second, with weak financial development, the tools available to manage boom-bust cycles are more limited. Third, some forms of trade specialization are prone to macroeconomic shocks. Specialization in natural resource-based exports is more cyclically vulnerable than in manufacturing, and that in ‘mid-tech’ manufactures (some of which have acquired commodity characteristics) is more cyclically prone than specialization in low- or high-tech manufactures.

All these short-term factors can easily prevent an economy from achieving *sustained* output growth at a rate of 2 per cent per capita or higher, effectively derailing long-term poverty alleviation. Effective counter-cyclical policy, pursued with some degree of control of external capital movements, may be the only solution.

## FINANCIAL STRUCTURES

In the discussion of poverty, microfinance is a highly salient topic. But what is usually omitted is any consideration of how the financial structure of the economy influences its available policy options and possibilities for sustained growth. These topics are taken up here.

Finance in any economy undergoes structural change. There is no strict progression of financial development and initial conditions matter. But, broadly speaking, new financial structures gradually evolve, in a process that can be seen as a sequence of stages. It is instructive to trace through four of them and consider, in particular, how different forms of finance constrain macroeconomic policy manoeuvre.

Stage I finance centres on the banking system. It lends to both government and the private sector and its liability, “money”, is the main source of liquidity. Two standard policy models follow directly from such retarded financial development. Despite their widespread application, both are anachronistic, especially after an economy proceeds beyond Stage I.

One model is the “financial programming” framework routinely utilized by the International Monetary Fund, especially in poorer regions of the world. It boils down to looking at the economy through “twin deficit” lenses. If the external deficit is to be reduced, the argument goes, the only way to do so is to cut the fiscal deficit, regardless of what the private sector does. In fact, private (*not* public) sector net borrowing tends to be closely linked with foreign borrowing. In the data for most economies, the twin deficits do not apply.<sup>4</sup>

The other model simply says that inflation is solely and uniquely caused by growth of the money supply. This particular version of monetarism has been discredited for decades in economies with relatively sophisticated financial structures, but still is relevant in Stage I—the hyperinflation after the mid-2000s in Zimbabwe is the most recent example.

Finally, in all financial stages, manias, panics and crashes (after Kindleberger and Aliber, 2005), a familiar scenario is based on government assets (with an asset price  $P_G$ ) which have been privatized and sold through a dealer to the public.<sup>5</sup> If the dealer happens to have a captive bank at his disposal, he can lend money to himself and to cronies to bid up the share price leading to a capital gain (or ongoing inflation) at rate  $\pi$ : the asset price rises to  $(1 + \pi) P_G$ . Other actors may then start borrowing from the captive and other banks to try to buy shares, setting off a boom that inevitably ends in a crash.

Premier examples were the Mississippi and South Sea crises early in the 18th century, in which John Law’s Banque Générale in Paris and the Swordblade Bank in London issued the loans. With international complications discussed below, the Chilean crisis of 1982–83 followed the same pattern around companies privatized by Pinochet’s Chicago Boys. These examples illustrate a recurring theme in financial instability: capital gains are financed by liquidity in the form of liabilities assumed by financial actors to buy the appreciating assets. Manifold possibilities along these lines emerge, even in economies with highly sophisticated financial structures—witness the 2007–09 crisis in rich countries all around the world! Output contraction and financial “deleveraging” always follow, with devastating effects on poverty reduction via economic growth.<sup>6</sup>

In Stage II finance, there is a market for government and/or central bank bonds. Keynesian ideas about liquidity preference come into play, with the interest rate mediating the portfolio choice between more liquid money and less liquid bonds (with government and central bank bonds being more liquid than those of the corporate sector, which are subject to interest rate spreads associated with both liquidity and solvency risks).

Given this degree of portfolio choice, the central bank can, in principle, intervene via open market operations (that is, buying and selling bonds) to

influence the interest rate—a clear gain in policy manoeuvrability over Stage I. A bond market also permits the government to raise finance for a development bank, an institution of considerable policy import, as discussed below.

In Stage III, national economic actors are able to borrow abroad in hard currency. This may be seen as the typical stage in which middle-income countries are placed today. Before the recent commodity price boom, sub-Saharan African countries had seen little development in their financial structures that would take them beyond Stage II or even Stage I, as they continued to be deprived of access to private external financing. In a growing group of somewhat more prosperous countries, however, the importance of bond markets, especially central bank and government bonds, has been on the rise over the years, and they have fared better in attracting external private finance, even if in an unstable way. These countries may be said to be firmly based on Stage III financing.

External borrowing obviously opens financial possibilities, but also creates potential problems. The presence of foreign liabilities in portfolios immediately exposes their holders to exchange rate risk due to currency misalignment or mismatch. If their assets and expected net revenues are denominated in domestic currency but their liabilities are denominated in foreign currency, then an increase in the exchange rate generates both capital and income losses. The higher rate cuts directly into net worth, and jacks up the cost of debt service. The threat to balance sheets is greater if (as has often been the case) there is a maturity mismatch involving short-term foreign liabilities and long-term domestic assets.

These dangers are especially grave for actors such as firms producing non-traded goods and the government itself insofar as their main sources of income are in local currency.<sup>7</sup> Although some assets of exporters (e.g., the real estate that they own and their deposits in the domestic financial system) may be denominated in local currency and subject to the same problems, they could be more than offset by the larger domestic value of their current and expected net income in foreign currency.

Money and credit expansion due to the accumulation of international reserves during phases of booming capital inflows has become a persistent problem in emerging market economies.<sup>8</sup> If there is a market in domestic bonds, the central bank can, in principle, “sterilize” the monetary effect of international reserve accumulation by selling its own or government paper in exchange for money in an open market operation, although at the risk of driving up interest rates, which may then bring in still more foreign capital.

In Stage I, the only options for sterilization are to reduce the public sector debt by running a budget surplus, or raising commercial bank reserve

requirements to “wipe up” the domestic money generated by the additional international reserves. These options are the only ones available if there is no well-developed domestic debt market. A long sequence of currency crises shows that such interventions may be of limited effectiveness.

Stage IV finance features the presence of stock markets, in the recent period, mostly the consequence of privatization of formerly public enterprises which account for the lion's share of equity on offer. Benefits include the possibility of initial public offerings of new shares which can be an incentive for entrepreneurship. As opposed to the practice in rich countries where share buybacks are prevalent, firms in semi-industrialized often raise funds by issuing new shares.

Risks of equity finance are, of course, also present. Variations on the Chilean speculative episode discussed above have occurred frequently over the past few decades.

## ECONOMIC STRUCTURE AND EMPLOYMENT

In the medium to long run, it is useful to analyze policy alternatives using a structuralist approach that goes back to Adam Smith. It was at the centre of development thinking from the 1940s to the 1960s, and has been recently reiterated by Reinert (2006), and formalized by Ros (2000) and Rada (2007). The latter combines Kaldor's (1978) idea that faster output growth in a “modern” sector stimulates productivity growth with the essential insight of Lewis' labour surplus model. The outcome is that the economy can be viewed as a combination of increasing returns (modern) sectors and more plodding constant or decreasing returns (“subsistence”) activities. Dynamics among markets, forces of innovation, finance and productive sectors can produce virtuous circles of growth and development based on decreasing costs per unit output. Smith realized, but did not emphasize that the invisible hand may need assistance in promoting sustained growth. As Alexander Hamilton and Friedrich List pointed out explicitly years later, conscious action, the visible hand, of the policy maker is often required.

The goal is to stimulate the sectors with increasing returns by shifting resources from elsewhere in the economy. The now industrialized economies succeeded in this task. The question is how to design policies that will facilitate similar processes elsewhere. Historically, the state has played a crucial role.

Let us suppose there is an increase in productivity growth in the modern sector. It can either stimulate or slow employment growth. In the former



case, faster modern sector employment growth means that job creation must necessarily slow down. If there are constant returns to scale in the subsistence sector, the output growth rate will be reduced by an equal amount. However, under conditions of decreasing returns combined with underemployment or surplus labour, subsistence income growth will fall by less than employment growth, still reducing demand for modern sector goods and reducing the sector's initial jump in job growth.<sup>9</sup> When feedbacks between the sectors work themselves out, faster productivity growth in the modern sector will still be associated with job creation, and subsistence output per capita will rise. Faster productivity growth in subsistence activities can also lead to better overall performance.

Now consider the case in which faster modern sector productivity growth reduces employment, in a case of "jobless growth". The foregoing results reverse, and the economy can easily fall into a low-level equilibrium trap dominated by subsistence activities.<sup>10</sup> A coordinated policy package may be needed to get modern sector growth underway. China's gradualist approach beginning in the late 1970s is an intriguing example. It began by supporting agricultural productivity growth through market manipulation to rig prices in favour of previously collectivized peasant producers. Joint ownership of land was retained with household operation of small and fragmented parcels. Mixed enterprises of various forms enabled mechanization and economies of scale. Producers responded strongly to the price incentives combined with institutional changes, which in effect amounted to land reform.

Subsequently, expansionary modern sector interventions combined with direct foreign investment to support export growth took centre stage. A low-level trap was avoided, but distributive tensions are rising with modern sector incomes now growing much more rapidly than real earnings in the countryside.

In another example, if the modern sector mostly produces traded goods and the subsistence sector produces non-tradables, then the model sheds light on the liberalization experiences spurred by the Washington Consensus. A deindustrialization trap can open.

As discussed above, capital account deregulation was, in many cases, associated with real appreciation and domestic credit expansion. Together with trade liberalization, the stronger exchange rate boosted demand for imports and penalized exports (also hit by removal of subsidies in some cases). The impact was to reduce modern sector employment creation. Offsetting influences were the credit expansion and rising private net borrowing during upswings. But even taking these factors into account, on the whole, liberalization was not associated with a strong increase in demand for traded goods.

Traded goods firms were faced with a choice between cutting costs or going out of business. Boosting labour productivity was the most important way to keep production underway. On both counts there was job loss. Unskilled workers bore the brunt of labour force reduction in traded goods, and shifted into informality and a range of subsistence activities. Distributive dynamics were driven by institutional circumstances in partly segmented labour markets, with details differing country by country. In many cases, stable or rising unemployment and unresponsive wages caused overall income distribution to become more concentrated. In others, expanding informal activity generated income increases for some poor households as growth lost traction. Short-term income increases for a few did not offset the loss in long-term income growth for the many.

The modern/traded goods sector in many developing economies across the world could have been supported by counter-cyclical policy, but for reasons discussed below, this option was not aggressively pursued. Directed sectoral support policies could have been deployed, but were ruled out by the non-interventionist prejudices of the Washington Consensus. Nevertheless, policies oriented towards supporting production are still on the table.

## FOREIGN AID

A well-known adage from Lao Tzu provides a concise description of two key effects of foreign aid: “Give a man a fish and you feed him for a day” means that external assistance can be a dole. But its true purpose is presumably to “teach a man (or a national economy) to fish and ... feed him for a lifetime”. As pointed out above, a rule of thumb for successful “fishing” is that the economy sustains at least 2 per cent annual per capita output growth. Employment creation should keep pace with the growing population.

Beyond Lao Tzu’s distinction, foreign aid has other complications. It certainly has helped launch 2 per cent or faster per capita growth performances in diverse policy environments. As noted above, the limited availability of hard currency is often the crucial bottleneck in a developing economy, holding down both supply and demand. If effective demand can increase because foreign exchange is available to pay for associated imports, it can stimulate private sector investment and innovation. At the same time, the imports can bring in essential goods and technologies to raise productive capacity. Here are examples:

The first, most successful aid efforts were the post-Second World War Marshall Plan in Europe and the parallel reconstruction programme in Japan.

They emphasized breaking forex bottlenecks (the “dollar shortage”) via coordinated public and private interventions—as opposed to the more recent obsession with market liberalization. It is worth recalling that the Americans who helped implement reconstruction were New Dealers at ease with an interventionist state.

In the 1960s and 1970s, illiberal and bureaucratically planned South Korea utilized capital inflows and US-guaranteed market access to create a formidable industrial base, beginning with textiles and going on to the world’s biggest integrated steel plant, and beyond into chip manufacture, automobiles and broadband internet coverage for over 90 per cent of the country. Korea’s international economic situation was a consequence of Cold War politics, but its planners took full advantage of the opportunities they had available.

In the “lost decade” of the 1980s, Chile performed better than the rest of Latin America because it received ample foreign assistance from international aid agencies favouring its neo-liberal policy stance. Increasingly sophisticated natural resource-based exports supported economic expansion.

Several economies in sub-Saharan Africa now have respectable growth rates with support from Nordic and other donors who provided steady aid flows over decades for their own geopolitical reasons.

In all these countries, big shifts in economic structure were created by a combination of technocratic top-down policy and spontaneous innovation from the bottom up. Even in neo-liberal Chile, the government consistently supported expansion of mineral and agro-exports. Mainstream opinion opposed state intervention, a viewpoint ignored at the time of the Marshall Plan or South Korea’s growth spurt.

Over the past two or three decades, many aid packages and economic “reform” programmes informed by the Washington Consensus did not generate linkages among demand growth, productivity and employment. Per capita income levels did not rise, and as discussed above, workers displaced by trade liberalization vanished into informal and subsistence activities. Under these conditions, foreign aid became, at best, a dole and, at worst, a cesspool for corruption.<sup>11</sup>

Certainly, aid can have positive impacts at the micro-level. A hand-out from abroad may cure smallpox or alleviate childhood malnutrition, but it is a hand-out notwithstanding. In recent decades, many poor economies have seen marked improvements in primary education (and health care as well), but have not been able to grow. Even if commendable and successful on their own terms, people-oriented technical fixes at the household level may not

directly stimulate economy-wide expansion and enduring poverty alleviation. For aid to generate desirable outcomes in terms of growth, several challenges must be overcome.

At the micro-level, human capital augmentation, just by itself, will not support steady growth unless high productivity enterprises get started.

Entrepreneurship is essential to this end, and should be rewarded.

But that will not happen spontaneously in a liberalized market environment. The state has to play a strong supportive role. Its available policy space has to expand so that countries can use instruments like sensible protection levels, targeted credit and production subsidies to direct their limited resources towards productive ends. Scale economies are potentially available in many lines of endeavour—the task is to identify and support them. Linking fetters on developmental policies to disbursements of aid—standard practice for the World Bank and IMF—is completely counterproductive.

Many sub-Saharan African countries are now finding a new solution: Chinese aid. Based on its own record of strong growth, this donor has, of course, no objections to a developmental state. It focuses on getting the economies to grow, based on exploiting the opportunities for raw material exports that China itself has generated. And it is not tied to the conditionality of the Bretton Woods institutions.

## POLICY ALTERNATIVES

The core idea is that there must be sustained growth in developing countries if poverty is to be reduced significantly. The policy agenda should promote changes in production and trade structures towards higher productivity sectors and utilization of idle resources, while at the same time, it advances the development of financial structures and the adoption of counter-cyclical macroeconomic interventions to manage both positive and negative external shocks. The “policy space” to adopt development and macroeconomic policies consistent with these objectives is crucial, as is overall policy coherence, particularly the coherence between short-term macroeconomic management and developmental goals.

Patterns of transformation will not necessarily be the same everywhere. The level of development and, particularly, the degree of diversification of production and trade structures already achieved, the accumulated technological capabilities, the natural resource endowments, and the size of the economies, all constitute a set of structural factors relevant for choices in the area of production sector policies. The extent of financial development and

the degree of integration into global financial markets constitute another set that will determine macroeconomic policy alternatives. Policy must always be context-specific, as it must take into account the specific structural features of a country and the international environment at a point in time. The mainstream search for “one size fits all” solutions, that was so typical of the Washington Consensus, is simply wrong. To have any chance for success, policy has to be tailored to each country’s conditions and constraints.

## MACROECONOMIC POLICIES

In the macroeconomic area, the two crucial issues are the need to enhance financial development and to design appropriate counter-cyclical macroeconomic policies. For poverty alleviation, other interventions may be crucial, for example, creating an adequate and progressive tax base to facilitate the adequate provision of social services and social protection as well as infrastructure development.

Financial development implies, first, the development of a sound banking sector and domestic bond markets. In the latter area, central bank and government bonds are commonly the starting point, but the final objective should be the development of deep corporate bond markets that facilitate investment financing. When long-term funds for investment financing are not available, public sector or state-sponsored development banks can play a very important role. They continue to be crucial when commercial banks and corporate bond markets provide financing with only limited maturity. Development banks and state intervention in general can also play a role in increasing access to finance for agents that have limited access to financial markets, including small firms and poor households, particularly in the latter case, for financing their major asset, housing.

Interestingly, state intervention is quite extensive in many of these areas, even under highly sophisticated financial markets (for example, in the United States). The development of bond markets, stock markets and other advanced forms of financing—such as sound securitized mortgages and sound derivative markets—may require promotion of specific institutional investors, which operate as “market makers”. Development banks, insurance firms and pension funds play a role in these areas in many countries; specific state-sponsored agents do the same, even in industrial countries (for example, in the case of the US mortgage market).

As emphasized above, the possibility of financial instability is present at all stages of financial development. Financial development has a dual effect in this area. On the one hand, a denser institutional network of financial agents

can be stabilizing and broaden the room for manoeuvre for counter-cyclical monetary policy. At the same time, however, new risks are created. They include: maturity mismatches between investment requirements and available finance, currency mismatches when external liabilities are used to finance the acquisition of domestic assets (particularly those producing non-tradable goods and services), excess leverage (the multiplication of financial liabilities relative to the capital base on which financial institutions operate) and even the sheer development of unsound financial instruments. These risks are present in all financial systems as reflected, for instance, in the importance of the latter two in the recent financial crisis in the industrial countries, including collateralized debt obligations based on subprime mortgages and credit default swaps backed by a very small capital bases. The first two sorts of risk are particularly important in developing countries, where variable mixes of maturity and currency mismatches are inherent to balance sheet structures.

Financial regulations must therefore become increasingly sophisticated as financial markets develop. Regulatory shortfalls are behind the high frequency of financial crises that have plagued the industrial and developing countries since the 1970s. Avoiding excessive leverage, and thus guaranteeing an adequate capital base in the financial system, as well as adequate provisions (or reserves) to cover expected losses, is the most basic issue. Almost equally important in developing countries is the management of maturity and currency mismatches. The simplest regulatory options are strict provisions or coverage for risk of balance sheets that have such mismatches, or quantitative limitations, or even outright prohibitions on foreign currency borrowing by domestic agents that produce non-tradable goods and services. And it should never be forgotten that over the centuries, newly invented, but unsound financial instruments have sparked many crises.

Finance is inherently pro-cyclical. Risks are accumulated during booms that are only evident at the end, when it is generally found that financial systems are seriously under-capitalized relative to the risks they have assumed. This recurring outcome lies behind a fundamental recommendation that prudential regulations should have a strong counter-cyclical component. One of the major problems behind current regulations is that they are actually pro-cyclical, including the pro-cyclical nature of credit ratings; the broad use of mark-to-market pricing, which fits transparency criteria but tends to transmit asset boom-bust cycles to portfolios; risk evaluation models that, due to their similar design, may actually make markets more volatile; and, more broadly, the tendency to build excessive leverage and open speculative positions during booms. The simple recommendations are to increase capital and/or provisions for loan losses during booms, and to avoid mark-to-market

asset pricing from feeding into leverage—by (for example) imposing limits during booms on the values of assets that can be used as backing for credit or bond issues.

Pro-cyclical finance also calls forth counter-cyclical macroeconomic policies. The key problem here is that the pro-cyclical availability of external financing limits the space available for developing countries to adopt counter-cyclical macroeconomic policies. Fiscal policies can always play a role, for example through progressive income taxes that would operate as an automatic stabilizer by increasing government revenues at a faster pace than overall economic activity during booms; or temporary tax hikes during these phases of the business cycle; the design of more effective permanent safety nets to support the vulnerable during crises; and fiscal stabilization funds to “store” temporary revenue upswings and rules that target “structural” fiscal balances—i.e., a deficit adjusted by pro-cyclical swings in tax revenues and the costs of safety nets used as automatic stabilizers during crises. In practice, however, the application of these principles is difficult, largely because political pressures lead governments to spend during booms, particularly when they were forced to cut spending during the preceding crisis as part of orthodox stabilization packages. Thus, unfortunately, pro-cyclical fiscal policies are a common pattern in the developing world—a trend that must certainly be reversed.

An even more problematic feature is the tendency of “parity” interest rates (the costs of external financing plus expected depreciation, or minus expected appreciation, of the exchange rate) to fall during booms and increase during crises. If countries follow these trends, monetary policies will be pro-cyclical and exacerbate swings in output. But trying to increase interest rates during booms and reduce them during crises, going against trends in parity rates, may simply worsen exchange rate instability. Indeed, higher rates during booms increase incentives to bring in more capital, reinforcing appreciation trends. Lower rates in a crisis can generate incentives to take capital out, thus enhancing exchange rate depreciation and the risks of recession or even a long period of foreign exchange scarcity if the economy has failed to diversify during the boom.

This sort of interaction is the true dilemma of monetary and exchange rate policies in open economies. Inflation targeting, the ruling paradigm of monetary policy, can provide a framework for counter-cyclical policies when domestic demand is the sole determinant of domestic prices. But its counter-cyclical effect is unclear when exchange rates are a major determinant of domestic prices and, in any case, by failing to set exchange rate or balance of payments objectives, it may result in excessive exchange rate fluctuations.

As a short run solution, exchange rate appreciation during booms will shift any excess demand towards the balance of payments. Although the inflation target may be met, the increase in the current account deficit and associated appreciation will become an element of vulnerability to a sudden stop in external financing. As a long-term solution, this choice entirely ignores the developmental dimensions of the exchange rate—i.e., the links between the exchange rate and the diversification of productive and trade structures.

Both from a short as well as a long-term perspective, macroeconomic policies in developing countries should therefore include an element of “exchange rate targeting” (Frenkel and Taylor, 2006). The massive interventions in foreign exchange markets in developing countries in recent years means that this is also a “revealed preference” of economic authorities in many, if not most countries.

The main contributions of macroeconomic policies to long-term growth are moderate and relatively stable long-term real interest rates, and competitive and relatively stable real exchange rates. The first can facilitate investment financing. The second can contribute to structural change in the production and trade structures. The exchange rate becomes more important as the trade regime is liberalized because protection and export subsidies become less readily available to promote structural change. (This effect of trade liberalization has often been ignored.) It is possible for macroeconomic authorities to set, within some limits, *both* interest and exchange rates. But this means that a mix of capital account regulations and (possibly massive) interventions in the foreign exchange market is necessary. It is a rewarding exercise, as empirical evidence indicates that exchange rate competitiveness has positive effects on economic growth in developing countries—or, what is a similar result, that a strong current account has positive effects, not only on short-term, but also on long-term growth.

## STRUCTURAL TRANSFORMATION POLICIES

The major task of structural transformation policies is to facilitate a dynamic restructuring of production and trade towards activities with higher technological content. We argued that countries that have industrialized have, in a broad sense, always pursued industrial policies, a statement that applies historically to the United States and Great Britain as well as to Japan and East Asian Tigers, among others. Industrial interventions have included trade policies (tariff and non-tariff protection, and export subsidies) and tax incentives, but also “pro-trust” policies to help create national champions and the active



utilization of military spending for industrialist objectives. The more aggressive Asian policy in the post-Second World War period is, furthermore, consistent with Gerschenkron's (1962) insight that active state intervention tends to be more important for latecomers and, we could add, for late-latecomers.

The Washington Consensus hit hard at these instruments and proposed that trade liberalization would be a less distortionary and more powerful instrument for development. This proved to be wrong. Trade liberalization has *not* been the instrument used by most successful developing economies, which have actively promoted the diversification of their production and exports towards sectors with higher technological content.

An appropriate integration into the world economy can, of course, be a powerful instrument of development policy. This concept has indeed always been at the heart of structuralist thinking. After all, according to the structuralists, the main objective of industrial policies was always to change the form of insertion of national economies into the global economic system—that is, to redefine the international division of labour, not to return to any form of “autarky” (a concept that is, in any case, irrelevant to understanding modern development). The real question then is what instruments developing countries can use to promote better insertion into the world economy today while supporting the incomes of the poor.

In this regard, trade instruments are less readily available than in the past, except for low-income countries, and intellectual property provisions are more stringent. A major instrument that has *not* been limited by international agreements is development banking. In many successful experiences, state-supported banks have been a major instrument for financing new development activities, at times mixed with some element of state ownership. Some countries continue to use this mix, most notably China. In today's developing countries, government-backed long-term lending should be combined with the encouragement of corporate debt markets, an activity that itself can be supported by development banks as “market makers”.

Several criteria have been discussed on how to design industrial policies today (see, for example, Amsden, 2001; Ocampo, 2005). The objective should always be the promotion of patterns of structural change that lead to the accumulation of technological capabilities. On the basis of the ongoing debate, several criteria can be proposed.

The major one can be formulated in a straightforward way: policies should promote *innovative activities that generate positive domestic spillovers*.<sup>12</sup> The concept of “innovative activities” should be understood in a broad sense, to refer not only to new technologies, but also new markets, new industrial structures, or exploitation of previously underutilized natural resources. In

today's export-oriented developing countries, export diversification, in either products or markets, should certainly be a major objective of these policies. In all cases, we should emphasize that "innovation" is what is "new" for the country or region where it takes place, regardless of whether this activity is fully developed elsewhere. Domestic spillovers—production linkages and technological externalities—are critical to justify government action, as benefits should go beyond the firm that undertakes the innovation.

Implicit in the emphasis on spillovers is that state intervention should aim at higher "value added", either in terms of technological content or at least of domestic content. Indeed, the latter follows from the fact that GDP is nothing else but value added. So, promoting pure assembly manufacturing or tourism with limited domestic contents is not desirable *per se*, unless that opens the space for further innovations down the line. It is perhaps paradoxical that the major forms of "industrial policy" in recent decades have been the promotion of free trade zones and the attraction of direct foreign investment through tax breaks or full tax exemptions—that is, activities that tend to reduce, rather than increase domestic linkages and value added while at the same time creating low-income, dead-end jobs.

In turn, the emphasis on "activities"—rather than "sectors"—raises a series of important questions. One is whether it is possible to separate an activity from the sector where it predominantly occurs. A particularly important case in this regard is whether it is possible to separate the process of promoting *production* from that of building *technological* capacities. The implicit assumption of old forms of industrial policy interventions was that the accumulation of technological capacities was closely tied to—in a sense, a by-product of the development of particular sectors. Promoting increasingly sophisticated industrial sectors was, therefore, the way to both promote innovation and the accumulation of technological capacities. Technological advancement *per se* became a passive, rather than an active process.

In today's world, the issue of whether to promote activities, rather than sectors, turns out to be a pragmatic question, of whether it is possible to de-link innovative activity from the innovative sector. There is probably no single answer. But what is clear is that, whether a specific activity or sector is promoted, and whether or not the "innovation" directly lies in the area of production (e.g., conquering new markets or exploiting new resources), what is essential is that the final goal is the accumulation of technological capabilities.

The emphasis on activities carries another message: as opposed to what was usually accepted in the past, sectors other than manufacturing also offer opportunities for innovation. They include modern services, but also primary

production, both in niche high value-added products (e.g., fresh fruits and vegetables) and also the technological upgrading of other natural resource-intensive activities.

These criteria apply at each stage of development, though in different ways, and open possibilities of active policies for all countries. How to increase productivity in basic agricultural activities—often the principal source of income for the poor—should be the starting point of any development policy in low-income countries. How to move from primary goods to resource based and low-skilled manufactures and services will be the challenge for low and lower-middle income countries, while middle-income countries increasingly confront the choice of moving to manufactures and services with higher technological content. For those producing resource-based goods or mid-tech manufactures subject to strong cyclical swings, an important element of the strategy must be how to diversify towards less cyclically vulnerable export sectors, and to accompany structural strategies with strong counter-cyclical macroeconomic policies.

Structural transformation strategies involve a public-private partnership of some kind. The need for such a partnership is associated with the information problems that different agents face: better information for the private sector on production processes and specific markets, but better information for the state on the economy as a whole, on international conditions and processes and, of course, its capacity to enforce rules that benefit the whole of the private sector, rather than individual agents. The nature of the partnership will vary from country to country, depending on the characteristics of both private agents and the state. In all cases, however, it should be understood as a mutual learning process.

The incentives that are designed may be horizontal (that is, an incentive that applies to a certain activity in all sectors) or selective. A preference for horizontal incentives may be correct in some cases, but they may be inadequate to promote the special activities that generate the strongest spillovers and associated accumulation of technological capabilities. It is important to emphasize that, when fiscal resources are involved, how to allocate them is always a selective decision and it is better to adopt it on the basis of an explicit strategy.

It is incorrect, however, to insist that any selective strategy involves “picking winners”—the typical claim of critics of industrial policies. Any successful strategy is a learning process, even on what should be promoted, and obviously involves the possibility of making wrong choices. This is true, by the way, of the strategies of individual firms in a free trade environment. The basic point is that the worst choice is to assume that the task

of designing appropriate structural development strategies is impossible, and therefore take a passive stance. Furthermore, rather than “picking winners”, the appropriate strategy may be characterized as “discovering” or even “making winners” in close interaction with production sector firms. This emphasis follows from our basic framework of analysis, according to which, productivity increases are, to a large extent, the result of production experience.

The decision-making process was no doubt simpler during the import substitution era, as it was based on what was imported and the size of domestic markets. For some export-oriented economies, looking at the export structures of countries with higher incomes may be appropriate. But, as industrializing economies (now South Korea, Taiwan, and in some aspects, China) approach the world technological frontier, hands-on administrative guidance of the old style may not work. However, even if the bureaucracy cannot foresee “the next big thing” in new technology-oriented sectors, it can certainly help finance research and development, and provide long-term finance to firms and the infrastructure backup in these sectors—as with South Korea’s 90+ per cent broadband internet coverage. None of these policy areas is restricted by international agreements, and these types of policies are actively practiced by states in industrialized countries today.

Incentives should be matched by performance standards—“reciprocal control mechanisms”, to use Amsden’s (2001) terminology. They should be granted on a temporary basis and dynamically adjusted to move forward in the structural transformation process. But any a priori definition of the duration of incentives may turn out to be artificial and could lead to the loss of resources invested without the policy objectives being met. A much better solution may be designing a learning process that would lead to decisions about whether to dismantle failed policies or extend successful policies until they bear their full fruits.

Finally, all of this requires investing in institution building. The destruction of institutional capacity in this area under the Washington Consensus was devastating in most of the developing world. But nothing indicates that it cannot be rebuilt. Indeed, mainstream analysis usually carries a very contradictory view regarding institution building. It is usually assumed that creating good central banks or tax authorities is within the reach of developing countries, but that promotion of productive sector development is somehow impossible. There is no reason why. Successful countries have shown that it can be done.

## INTERNATIONAL ENVIRONMENT

Although the discussion here has focused on domestic macroeconomic policies and structural development strategies, the international environment is critical, as clearly indicated by the clustering in time of successes and failures across a broad range of countries. So, designing better instruments for global macroeconomic policy management is essential for developing countries, as is adequate voice and participation in associated decision making.

And we should finally underscore, once again, that international rule making should leave enough “policy space” for developing countries to adopt strategies and policies to manage external shocks and promote their structural transformation. This is an area where there has been a clear regression in recent decades. A more equitable world is certainly not a world based on rules that make development more difficult.

## PRO-POOR POLICY ORIENTATION

The main point of this paper is that serious poverty eradication is impossible without sustained growth in per capita income. Some countries have fared relatively well in maintaining economic growth; many more have not.

Growth does not occur without ongoing structural change. Policies that may promote growth have been suggested, most notably avoiding, insofar as possible, pro-cyclical responses to macroeconomic shocks (most importantly, shocks that impact the economy from abroad); steering macroeconomic prices, such as the exchange and interest rates, to support developmental objectives; pursuing industrial and trade policies that support economic activities that can generate increasing returns; promoting financial development; and making productive use of foreign aid.

Of course, policies targeted directly at helping the poor (for example, by attempting to reach the MDGs) have an important role to play. But unless there is sustained growth in per capita output along with significant job creation, they will not succeed. Returning to Lao Tzu, teaching national economies to “fish” successfully for sustained growth and structural change is the overriding policy concern.

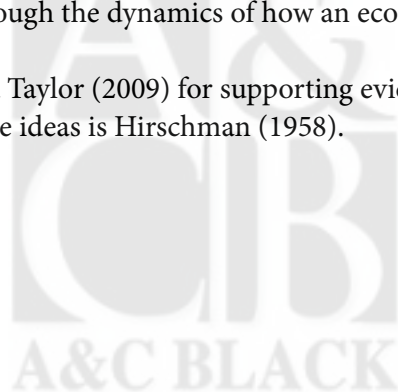
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## NOTES

- 1 This analysis draws on Ocampo, Rada and Taylor (2009).
- 2 At times, in this paper, developing and transition economies are referred to separately, but generally, the terms "developing" countries or economies and "developing world" refer to both groups.
- 3 With open capital markets, domestic interest rates are closely tied to the foreign rate plus a country-specific "spread". The spread tends to fall when the economy is growing and to rise when it is in a slump, rendering counter-cyclical monetary policy virtually impossible.

- 4 See Ocampo, Rada and Taylor (2009) for the evidence.
- 5 The “assets” might be claims on hypothetical future revenue streams (the South Sea and Mississippi cases discussed below) or equity of former state enterprises (a standard case in late 20th century developing country crises).
- 6 “Leverage” is the ratio of assets to net worth (or total assets minus debt). Paradoxically, when asset prices rise, the proportional change in the numerator is less than in the denominator. Leverage thereby decreases, providing an incentive to take on more debt to buy more assets in a financial upswing. Ultimately, asset prices peak and start to fall. Leverage becomes “too high”, provoking fire sales of assets and plummeting prices as deleveraging gets underway.
- 7 A recent twist in Eastern Europe took the form of households obtaining mortgages in euros or Swiss francs, with disastrous results when the local currencies depreciated.
- 8 If the exchange rate stays constant, the home country’s net foreign assets can only change gradually over time via a surplus or deficit on current account. Hence, a jump in foreign lending must be met by an equal increase in reserves which can stimulate money and credit expansion through the usual channels.
- 9 The basic idea comes from Sen (1966). He assumed that the elasticity of subsistence output with respect to employment is zero. Constant returns imply an elasticity of one. In reality, the elasticity probably lies between these extremes.
- 10 Rada (2007) works through the dynamics of how an economy can be caught in a low-level trap.
- 11 See Ocampo, Rada and Taylor (2009) for supporting evidence.
- 12 The key source for these ideas is Hirschman (1958).



## Chapter 3

# Governance, Growth and Poverty Reduction

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MUSHTAQ H. KHAN

The debate about policy and poverty reduction touches on three interrelated issues: the measurement of poverty, the arithmetic decomposition of poverty reduction into growth and distribution effects and the causal relationships between growth, distribution and policy variables affecting them. The appropriateness and accuracy of measures of poverty have come under repeated scrutiny. There are wide variations in the measures, and small changes in underlying measurement techniques can have significant effects on measured poverty. These measurement problems make it difficult enough to identify trends, and certainly make it very difficult to test complex causal relationships with satisfactory degrees of confidence. On the other hand, the arithmetic relationship among mean incomes, income distribution and poverty is relatively simple, and can be used to decompose poverty reduction into income growth and distribution components. But these decompositions do not directly tell us much about the *causal* relationships among growth, distribution and the variables that jointly affect them, which have been the subject of considerable debate. This chapter focuses primarily on these causal links, looking particularly at the likely causal relationships between good governance reforms and poverty reduction, operating through effects of governance reforms on distribution. But we begin by outlining the key measurement and arithmetic issues underlying the analysis.

### MEASUREMENT ISSUES

Poverty is typically measured by the headcount measure, the proportion of the population below a commonly agreed poverty line. In recent years, the \$1 a day line used by the World Bank has achieved wide usage. The first set of poverty measures using this line was published in the *World Development Report 1990* for 22 countries for 1985, using 1985 PPP to convert the dollar-a-day line into local currencies. In 1993, PPP data were substantially revised



and improved, and using these numbers, a new poverty line was chosen from the median of the 10 lowest national poverty lines which gave a figure of \$1.08 at 1993 PPP. This figure (still described as the dollar-a-day line) was the basis of subsequent World Bank estimates of national and global poverty until the international poverty line was further updated to \$1.25 in 2005 PPP prices. The new 'dollar-a-day' line emerged as the mean of the national poverty lines of the fifteen poorest countries converted into 2005 PPP dollars. Clearly, changes in the dollar-a-day line were not made to ensure that a similar basket of nutritional or other characteristics could be purchased by those PPP dollars over the years. Rather the particular level of the line was derived as the mean or median of an arbitrarily chosen set of national poverty lines converted into PPP dollars. As a result, it is not clear that the Bank's headcount poverty measures over time identify the proportion of population below a fixed absolute consumption level (Reddy and Pogge 2005; Ravallion 2008a, 2008b).

A further problem with these standard World Bank poverty measures is that they are very sensitive to estimates, both of the conversion rate of the PPP dollar poverty line into local currency using the PPP conversion rate for the benchmark year, and then of the conversion of this local currency poverty line for the benchmark year into a poverty line for the current year using consumer price indices. Changes in the estimates of the PPP conversion rate or the consumer price index can significantly alter estimates of poverty. Updating price data explains some of the significant changes in the estimates of global poverty that the World Bank has been forced to announce. For instance, the revision of PPP estimates in 2005 and the revision of the poverty line from \$1.08 at 1993 PPP dollars to \$1.25 at 2005 PPP dollars resulted in the estimate of the proportion of global population living in poverty increasing from 17.2 to 25.7 per cent, an obviously massive change in the numbers (Chen and Ravallion 2008: Table 4).

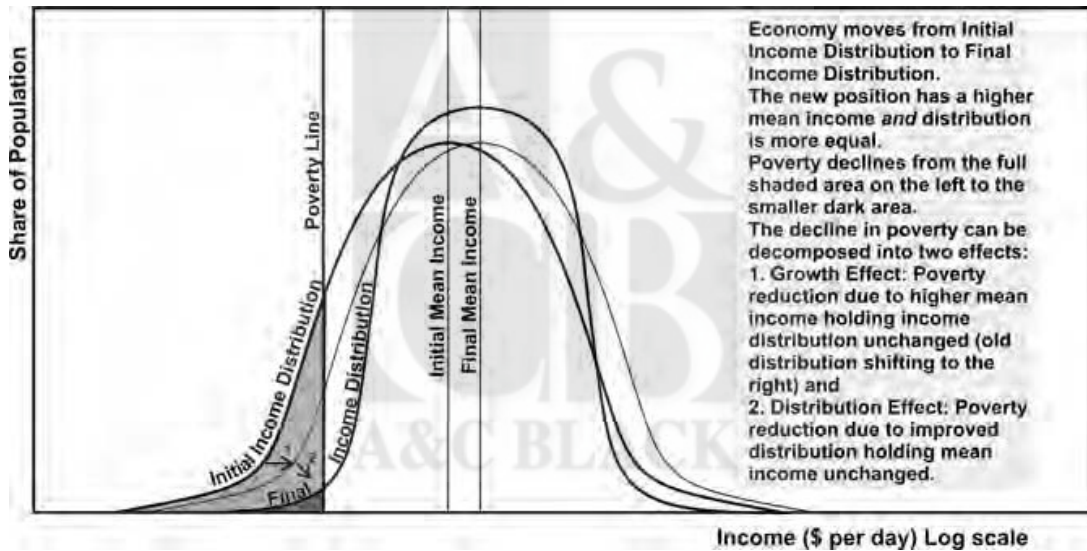
Finally, computing the conventional headcount poverty measure requires the use of national income distribution statistics typically derived from expenditure or income surveys, and these vary significantly in quality across countries and over time within countries. These data issues need to be kept in mind when we comment on changes in poverty in developing countries based on these numbers. Even so, the headcount ratio is the simplest and crudest of the measures of poverty. It ignores the distribution of poverty under the line. Other measures of poverty that take the distribution of poverty below the poverty line into account are even more difficult to estimate (Datt and Ravallion 1992). These significant data issues mean that we are not in a position to trace the effects of policy with any precision. The data are at best able to indicate very broad trends, and even that with significant qualifications.

## THE ARITHMETIC OF GROWTH, DISTRIBUTION AND POVERTY REDUCTION

Poverty reduction is arithmetically related to growth and changes in income distribution. The density function describing the share of the population that receives each per capita income provides all the information required to estimate any measure of poverty. That density function, in turn, can be described by its mean and the shape of the distribution around that mean. The headcount measure of poverty is simply the area to the left of the poverty line under the density function shown in Figure 3.1 adapted from Bourguignon (2004: Figure 1). If we look at the initial distribution of income in Figure 3.1, the proportion of the population below the poverty line is specified by the shaded area in grey.

Figure 3.1:

**Decomposition of poverty reduction into growth and distribution effects**



Changes in the level of poverty can be related to changes in per capita incomes (a shift of the density function usually to the right) and changes in the distribution of this income (a change in the shape of the density function). If the distribution of income stays constant, income must have changed for all income groups at the same rate. In Figure 3.1, the logarithmic horizontal axis ensures that a rightward shift of the density function will entail the same percentage change in the incomes of all groups. Moving the density function to the right therefore shows a pure growth effect with no change in the distribution of relative incomes. If distribution worsens (incomes rise faster for richer groups), poverty reduction will be slower because incomes of poorer groups will be rising at a rate lower than the average (the area under the curve at the bottom will increase). In contrast, if distribution improves, poverty reduction will be faster because the

incomes of poorer groups will be rising faster than the average, so that not only is the density function moving to the right, it is also moving downwards at the bottom end (Datt and Ravallion 1992; Kakwani 1993; Bourguignon 2004).

Figure 3.1 shows that when both mean incomes and the distribution of relative incomes change, the overall change in poverty can be decomposed into a growth component (the change in poverty, holding distribution constant) and a distribution component (the change in poverty, holding mean income constant). In the example in Figure 3.1, per capita incomes are increasing *and* distribution is becoming more equal. The decomposition shown in Figure 3.1 allocates the entire reduction in poverty to a growth effect and a redistribution effect, but this neatness is achieved because the decomposition is done sequentially. A different sequence may suggest a slightly different breakdown if the redistribution effect is identified first, and the growth effect second. A mathematically correct decomposition would calculate the growth effect with reference to a determinate reference distribution and the redistribution effect with reference to a determinate reference mean income. In this technically correct method, the contributions of growth and redistribution do not depend on the sequence of decomposition, but the overall decomposition will usually entail a small residual which cannot be uniquely attributed to either growth or redistribution (Datt and Ravallion 1992: 276–279).

The decomposition of poverty into growth and redistribution provides a number of arithmetic insights that are not in dispute. First, poverty reduction will be faster if the growth of per capita income is higher, and/or if income distribution is improving. Secondly, since income distribution cannot keep improving and has, in any case, an arithmetic upper bound when all incomes become equal, the long-term driver of poverty reduction must be growth. In most countries, the feasible upper bound on distribution is likely to be arrived at much before full equality. But thirdly, income distribution in most developing countries is so far away from equality that significant poverty reduction is arithmetically possible for a while if distribution improves. Fourthly, for any given growth rate of per capita income, poverty reduction will be faster if incomes are more equally distributed to begin with. These arithmetic facts are not in dispute, but they do not help to resolve the intense disputes about *causality* and the appropriate content of poverty reducing policies.

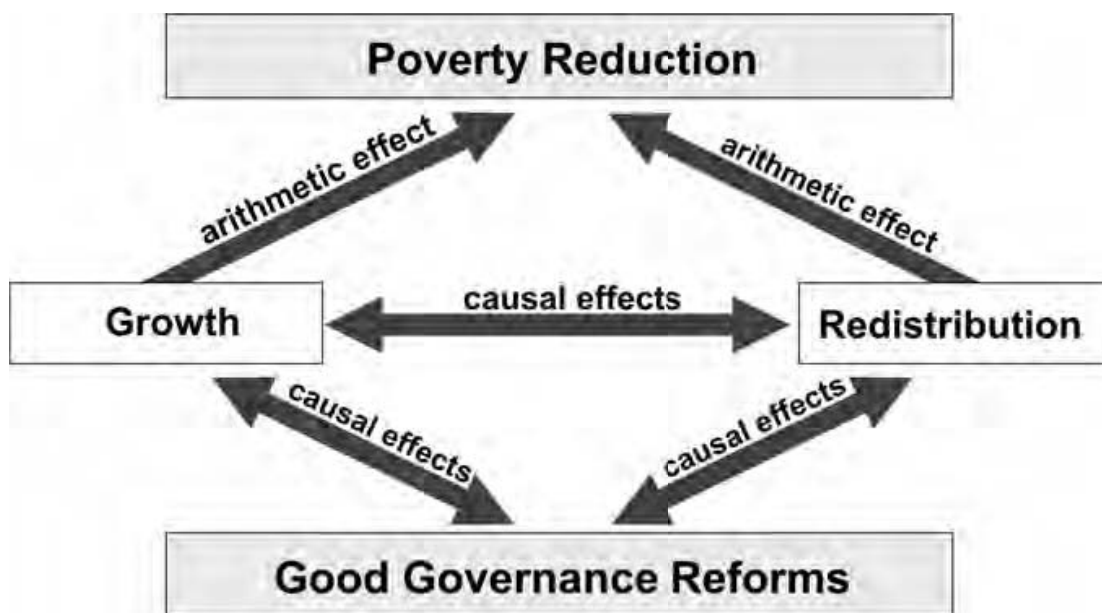
#### CAUSAL LINKS BETWEEN GROWTH, REDISTRIBUTION AND GOVERNANCE

A wide range of contradictory causal relationships have been suggested between growth and redistribution. The inconclusive empirical testing of these possible hypotheses suggests that the relevant relationships may vary significantly across

countries, regions and periods. The causal relationships relevant for particular countries are nevertheless important, because it may be that higher growth may require policies that slow down or reverse improvements in distribution, or it may be that higher growth requires improvements in income distribution. The causal relationships between distribution and growth relevant for a particular country have significant implications for poverty reduction. For instance, if improvements in distribution have a negative effect on growth, an excessive focus on redistribution may have negative growth effects that could more than offset the positive redistribution effects for poverty reduction.

The causality between growth and redistribution can also run in both directions. Growth may, in turn, have causal effects on distribution that may be positive or negative, and again, there are obvious implications for poverty reduction. Finally, both growth and distribution are likely to be responsive to policy and these policies can be judged in terms of their impact on growth and redistribution. The optimal policy mix would depend on the effective relationships between growth and distribution. For instance, a specific policy to achieve higher growth may not be recommended if it has very adverse implications for distribution if we are concerned about immediate poverty impacts. In turn, both growth and income distribution can determine the effectiveness of specific policies, because the political feasibility of implementing particular policies may depend on the environment of growth and distribution. As we are particularly concerned with governance reform, Figure 3.2 summarizes these interdependencies among growth, redistribution and policy with reference to strategies of implementing good governance reforms.

Figure 3.2:  
Causal Links among Governance, Growth and Redistribution



## GROWTH-REDISTRIBUTION CAUSAL LINKAGES

The two-way horizontal arrow in Figure 3.2 shows the critical and possibly two-way causal relationships between growth and distribution that have been the subject of considerable debate. Many types of interactions between growth and distribution are theoretically possible. An important link operates through the savings-investment effect. But as Figure 3.3 summarizes, the savings-investment link between distribution and growth may take radically different signs depending on often implicit assumptions about initial conditions and the presence or absence of other necessary institutional and economic conditions. The classical position on the direction and sign of the savings-investment effect was articulated by Kaldor (1957), drawing on the classical political economy insight that growth in capitalist economies is driven by the investment of profits. As profits are the incomes of capitalists, the higher investments that drive growth may be associated with a more unequal distribution of income.

This argument can be interpreted to imply that greater equality would have a negative effect on growth. What is often not clearly articulated is that even if higher profits were associated with greater inequality, this would only imply higher growth rates if other factors were conducive to sustaining high levels of investment. There is no point having high levels of profits if expectations of future profitability are weak and investments in potential growth sectors do not take place. So we should not be surprised if we do not find an overall relationship between inequality and growth in cross-sectional analysis looking at all countries together. However, for particular countries where complementary conditions were conducive, the Kaldor effect may be plausible.

Figure 3.3:

**Theoretical linkages between growth and redistribution**

The savings-investment effect can also directly suggest the opposite relationship between equality and growth. Amartya Sen's capabilities approach to development can be interpreted as saying that greater equality would be good for, or at least compatible with, poverty-reducing growth (Sen 1999).

Redistribution to the poor would allow higher investments in areas like health and education that enhance the capabilities of the poor to participate in growth. Variants of this argument point out that a failure in capital markets can prevent the poor from accessing capital if their initial endowments of assets are too low. These arguments are also theoretically plausible, but equally, there is likely to be little point in building capabilities for the poor, in the way Sen's argument suggests, if employment opportunities for the somewhat educated poor do not also emerge. The poor are unlikely to be able to create globally competitive employment opportunities for themselves, simply because they have some basic capabilities, and given the scale of investments required to achieve global competitiveness. Thus, it is not surprising that some developing countries and regions with above average education underperform in terms of growth because of poor employment generation. These economies often become exporters of skilled labour rather than high-growth economies. The cases of Kerala within India and of the Philippines in South East Asia are particularly relevant (ADB 2007: 317–338).

A second linkage between distribution and growth operates through the mechanism of political redistribution, shown by the arrow growing through the lower box in Figure 3.3. Examples are Alesina and Rodrik (1994) as well as Persson and Tabellini (1994) who suggest that inequality would have a negative effect on growth by creating pressures for taxation and redistribution. Attempts by political organizations to achieve this redistribution, in turn, have a dampening effect on growth. Curiously, the reason that inequality leads to low growth in these models is that political attempts to *improve* distribution in societies with initially poor distribution result in adverse effects for investment and growth!

The political economy behind many of these models is implausibly simplistic. It is not possible to say much that is useful even about the sign of the relationship between initial distribution and political responses to it without a fuller picture of the political structure of a country, its level of development, the structure of its economy and so on. For instance, a society that is very unequal may have fewer distributive conflicts if the poor are really poor and disorganized compared to one that was more equal but had powerful intermediate classes who could lead the mobilization against the rich. Similarly, whether redistributive demands lead to conflict and low investments would depend on the political responses of the rich, their productive capability of meeting redistributive demands and the agenda of the political leadership that would determine what is done with the redistributed incomes.

Finally, as Figure 3.3 shows, growth can directly affect distribution as suggested by Kuznets (1955). Kuznets suggested that as the capitalist or

modern sector in developing countries grew, income inequality would initially worsen and then eventually improve, implying an inverse U-shaped relationship between per capita income and inequality. His argument depended on the possibility that mean income in agriculture was lower and distribution is relatively more equal than in the emerging industrial sector. As labour moved from agriculture to industry, income distribution would initially worsen despite overall mean incomes growing. This argument suggested that growth in poor countries could lead to greater inequality, but growth in middle-income or richer countries could lead to improvements in equality. However, even in poor countries, poverty would be unlikely to increase as a result of growth because for the economy as a whole, the positive growth effect would be likely to at least balance, if not outweigh, the negative redistribution effect. The Kuznets effect is to be distinguished from the Kaldor effect, where growth may require an increase in savings, and therefore, a prior worsening of income, and may theoretically result in increases in poverty for a time.

Not surprisingly, given the number of plausible theoretical relationships between growth and distribution with opposite signs and directions of causality, the empirical evidence is indeterminate. Each of these plausible mechanisms depends on implicit institutional, political and economic conditions being appropriate. In cross-section studies where country-specific conditions are almost impossible to fully account for, the overall relationships observed are likely to be either indeterminate or spurious. Alesina and Rodrik (1994) as well as Persson and Tabellini (1994) provide some empirical support for the hypotheses that higher initial inequality results in lower growth. On the other hand, Forbes (2000), using a better data set on income inequality and using panel data to limit the impact of regional effects, finds a positive relationship between inequality and growth at the level of countries. This suggests that when we look at individual countries, periods of rising inequality are associated with subsequent growth accelerations, consistent with the Kaldorian relationship between inequality and growth.

The panel data analysis suggests that the negative relationship between inequality and growth in some cross-section regressions may have been capturing regional effects because many low-growth regions happened to have relatively poor income distribution. A positive relationship between inequality and growth along the lines of Forbes is also reported by Li and Zou (1998). In their test of Kuznets using panel data, Deininger and Squire (1998) find a very weak relationship between growth and inequality. Since a relationship does exist in cross-sectional data, they suggest that the Kuznets relationship could also be picking up regional effects. None of these studies attempt to test these relationships using more sophisticated theories which

identify the specific conditions under which relationships of a particular sign and direction of causality may hold. One reason for this is the thinness of the data and the very limited time periods over which distribution data are available for developing countries.

### GOOD GOVERNANCE AS MARKET-ENHANCING GOVERNANCE

Keeping these fundamental questions about the relationship between growth, distribution and poverty in mind, we can look at the important policy area of governance reform to see how these reforms may affect poverty. We can examine this by looking at the possible effects of governance reforms on growth and distribution. Much of the emphasis of good governance reforms has focused on the likely effect of these reforms on growth. The anomalous nature of good governance on growth has been examined elsewhere (Khan 2007). Here, we will focus on the likely effects of good governance reforms on poverty through possible effects on distribution. But first, we need to briefly describe what good governance reforms refer to.

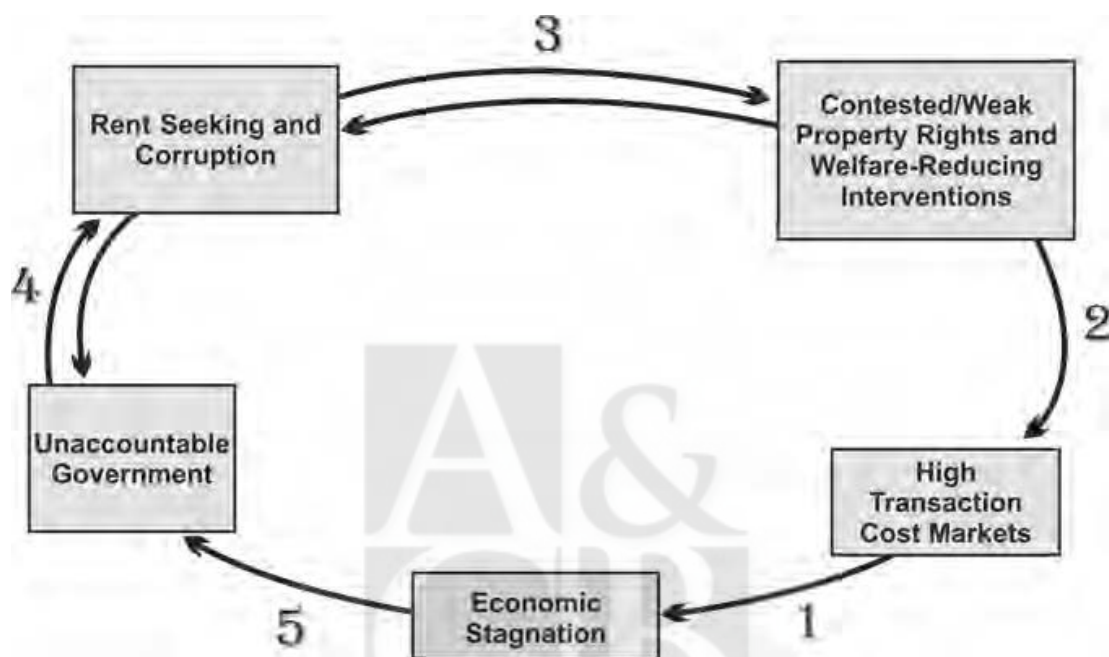
Governance reforms refer to strengthening state capabilities to enforce institutional rules that are important for economic and social development. The dominant 'good governance' paradigm identifies a series of capabilities that, it argues, are *necessary* governance capabilities for a market-friendly state. These include, in particular, the capabilities to protect stable property rights, enforce the rule of law, effectively implement anti-corruption policies and achieve government accountability. Many of these capabilities are clearly desirable as they help to achieve conditions that are desirable. But in the good governance framework, these capabilities are not just *desirable for achieving some of the goals of development*. Rather, good governance capabilities are identified as *preconditions for development* because they ensure that markets will be efficient and less subject to market failures (Khan 2007).

The new consensus draws on a particular reading of the New Institutional Economics to derive these conclusions. A core proposition is that efficient markets are achievable in developing countries, and efficient markets will drive development. The inefficiency of markets in developing countries is the source of market failures that constrain development. These inefficiencies are due to high transaction costs in developing country markets, which are, in turn, due to poorly protected property rights and welfare-reducing rent-creating interventions. Unstable property rights and welfare-reducing interventions, in turn, persist because some individuals and groups benefit from



these instabilities and interventions. And finally, damaging rent seeking and corruption continue because of weak accountability and a lack of effective democracy, which allow a minority to benefit at the expense of the majority. The links in the argument are summarized in Figure 3.4.

Figure 3.4:  
Causal links in the good governance argument

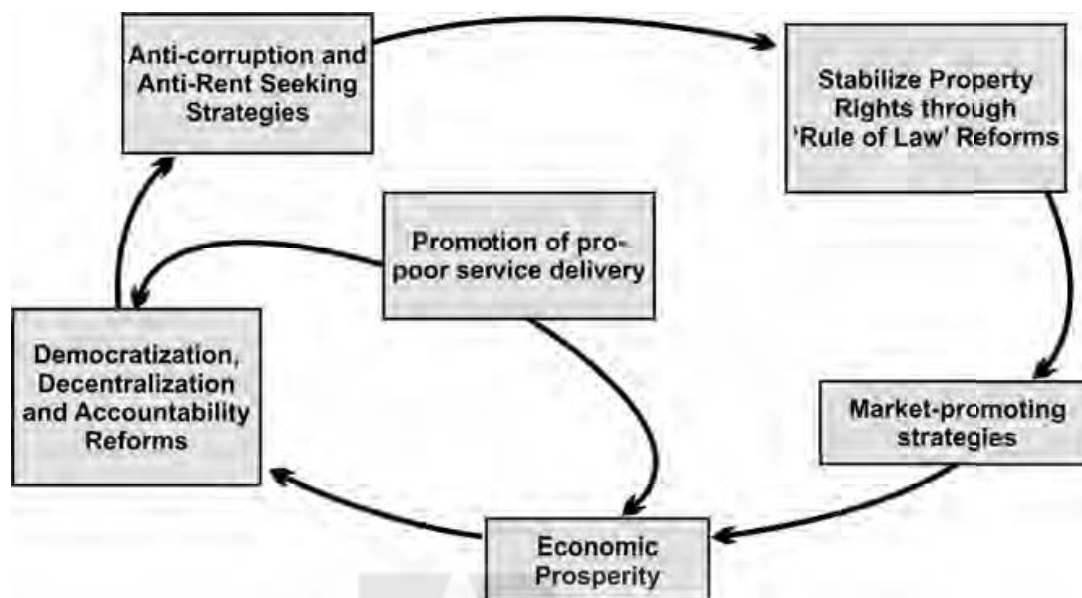


Source: Khan (2008: Table 4)

The good governance agenda therefore aims to reduce the market transaction costs which are theoretically the source of important market failures. The expectation is that strengthening the requisite capabilities will reduce market transaction costs, which in turn will drive development. This is why in Khan (2007) and elsewhere, we described the 'good governance' agenda as one of *market-enhancing governance*. To the standard liberalization strategies which have been the core component of the international development consensus, the good governance agenda adds a number of simultaneous reform priorities. Most of these follow directly from the links identified in Figure 3.4 and are shown in Figure 3.5.

States have to achieve capabilities for protecting property rights and contracts using the rule of law. These require capabilities for fighting corruption and rent seeking, which, in turn, have to be bolstered by reforms promoting democratization, decentralization and accountability. The final component often added to the package by development agencies is the promotion of

Figure 3.5:  
The good governance policy agenda



Source: Khan (2008: Table 5)

pro-poor service delivery as a way of mobilizing the poor who are the majority or close to the majority in poor countries. If this group can be mobilized to hold the state to account by ensuring that the state delivers to them, then the accountability essential in this framework can be kick-started. The importance of pro-poor service delivery in this governance approach is therefore not simply in the direct effect on poverty (initially funded mainly by external agencies), but primarily to establish the virtuous cycle of governance which, in theory, will sustain market-led growth.

### *Good Governance and Growth*

We have argued elsewhere that the expectation that implementing good governance reforms in developing countries will drive growth is unlikely to be met. This is not because the theory is implausible, but because there are structural and fiscal constraints that prevent the achievement of significant improvements in the good governance capabilities shown in Figure 3.5. As a result, the achievement of lower market failures through this route is likely to be very limited. Indeed, when we compare high-growth and low-growth developing countries, we do not find significant differences in their scores on good governance (Khan 2004, 2008). High-growth developing countries do

not, in general, have better governance compared to other developing countries in terms of their good governance capabilities. But case study evidence suggests that developing countries that have sustained high growth over long periods did have significant governance capabilities to identify and address significant market failures.

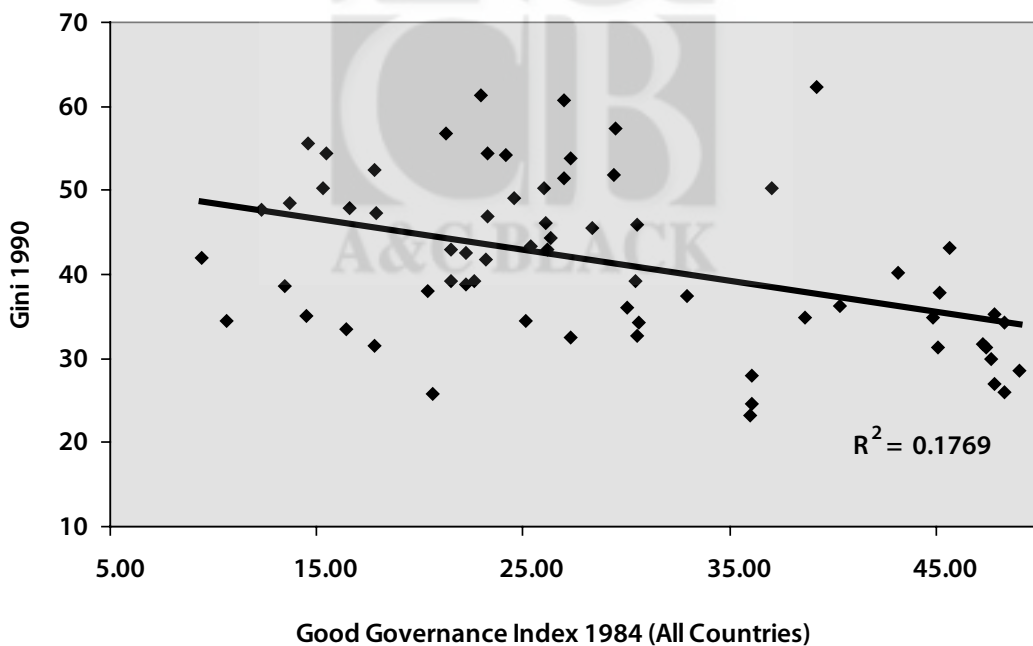
These observations suggest that developing countries that focus exclusively on good governance reforms are not likely to achieve significant improvements in their growth rates as a result. Indeed, they are unlikely even to achieve significant improvements in good governance across the board given the structural and fiscal constraints that we have referred to. The achievement of good governance goals—like the stabilization of property rights, the achievement of good rule of law or the significant reduction of corruption—require fiscal capabilities not available in the typical developing country. In this context, market failures are likely to remain significant and serious, and are unlikely to be significantly reduced by good governance reforms. Developing countries therefore also need to focus on alternative governance capabilities that enable them to directly address market failures. We have elsewhere described this as a *growth-enhancing governance* agenda which focuses on developing governance capabilities appropriate for directly addressing a limited number of important market failures in particular developing countries (Khan 2007, 2008).

### *Good Governance and Distribution*

While the impact of good governance on growth is unclear at best (Khan 2004, 2007, 2008), it is possible that good governance reforms may have an impact on poverty reduction by improving income distribution in poor countries. If so, the implementation of good governance capabilities may have a positive impact on poverty in poor countries. This is primarily likely to happen through the pro-poor service delivery aspect of good governance reforms shown in Figure 3.5, but also through the protection of property rights and the rule of law, through anti-corruption policies and democratization, all of which could, in theory, allow the poor to protect their rights better, demand better services from the state, and ensure that a greater part of the public goods that they are entitled to are in fact delivered. If so, even if good governance reforms had an anomalous effect on growth, it may have an effect on poverty by improving distribution.

The quality of the data available on distribution and the short-time periods over which indices of good governance are available do not allow us to do much more than look at some broad features of the possible relationship. To begin with, we need to have data for governance at some time in the past and data on distribution in a subsequent period so we can ask if countries with better scores on good governance ended up with better income distribution compared to other countries. The earliest cross-country data on governance comes from the IRIS-3 (2000) project based on surveys and expert opinions. This provides a series of governance indices beginning in 1984 on corruption, rule of law, bureaucratic quality, contract repudiation and expropriation, which can be blended to give a combined index of good governance on a scale from 0 to 50. The most comprehensive data on distribution for the late 1980s and early 1990s comes from Deininger and Squire (1996) who collate the best available Gini measures of income distribution for a set of countries.

Figure 3.6:  
**Good governance and distribution, 1990 (all countries)**



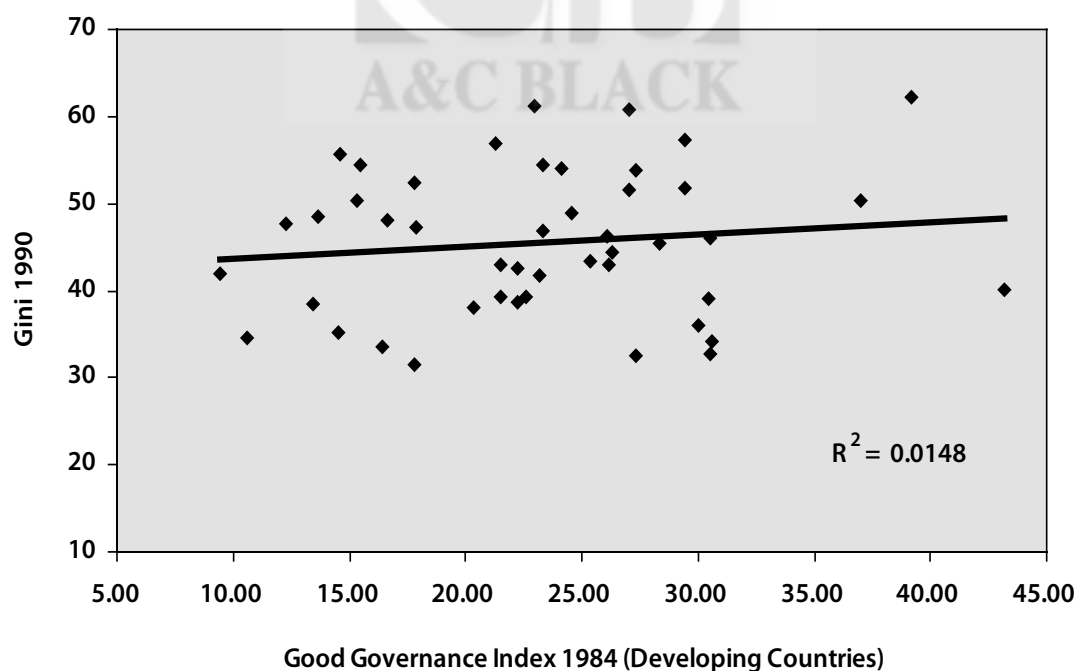
Sources: IRIS-3 (2000) and Deininger and Squire (1996)

Figure 3.6 looks at the relationship between good governance scores and income distribution in the 1980s using these figures for the full set of countries for which data are available. There is no obvious pattern in the scatter diagram, but a weak negative relationship appears when we fit a line, suggesting that countries with better governance may have had a tendency to have better income distribution. However, this disappears entirely if we exclude advanced countries from the data, as shown in Figure 3.7. Although this fit is very poor, the fitted line now has a positive slope, suggesting that developing countries with better governance tended to have worse income distribution than the others. But, in fact, the scatter suggests the absence of any obvious relationship.

For the 1990s, we have governance indicators from 1996 onwards in the Worldwide Governance Indicators collated by the World Bank (World Bank 2008b). These are indicators for a number of good governance variables compiled from internationally available indicators. The indicators for each aspect of governance are normalized to have a mean of zero for each variable for each year, so they cannot be blended together to provide a composite good governance indicator (or one easily compared across years) for that country. We have used the three indicators most directly related to the good governance agenda: the rule of law, control of corruption and voice and

Figure 3.7:

**Good governance and distribution, 1990 (developing countries)**



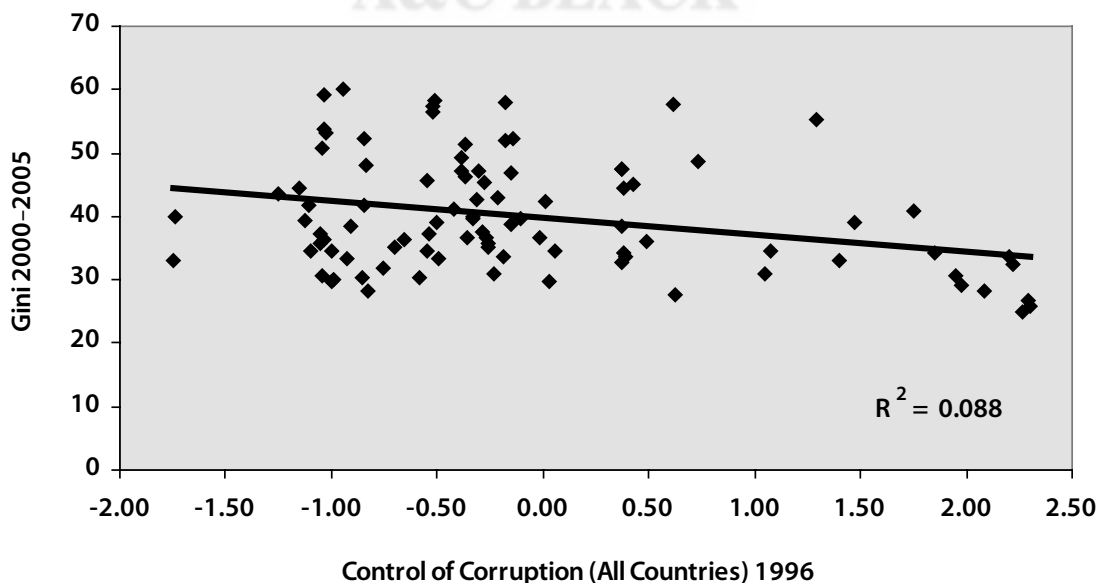
Sources: IRIS-3 (2000) and Deininger and Squire (1996)

accountability. The subsequent income distribution data used was the average of the Gini indices for countries available from the World Bank's World Development Indicators for 2000–2005 (World Bank 2008a).

We used only those countries for which all three governance indicators were available for 1996 and for which at least one Gini observation was available for 2000–2005. Where more than one observation was available, we used the average. The relationship between these governance indicators and their subsequent distribution, for all countries for which all the relevant data were available, is shown in Figures 3.8 to 3.13. As with the 1980s, the data for the 1990s show that while there is, at best, a very weak positive relationship when we pool all countries together (better governance leads to more equal income distribution), the relationship entirely disappears or takes the wrong slope when we look at developing countries separately.

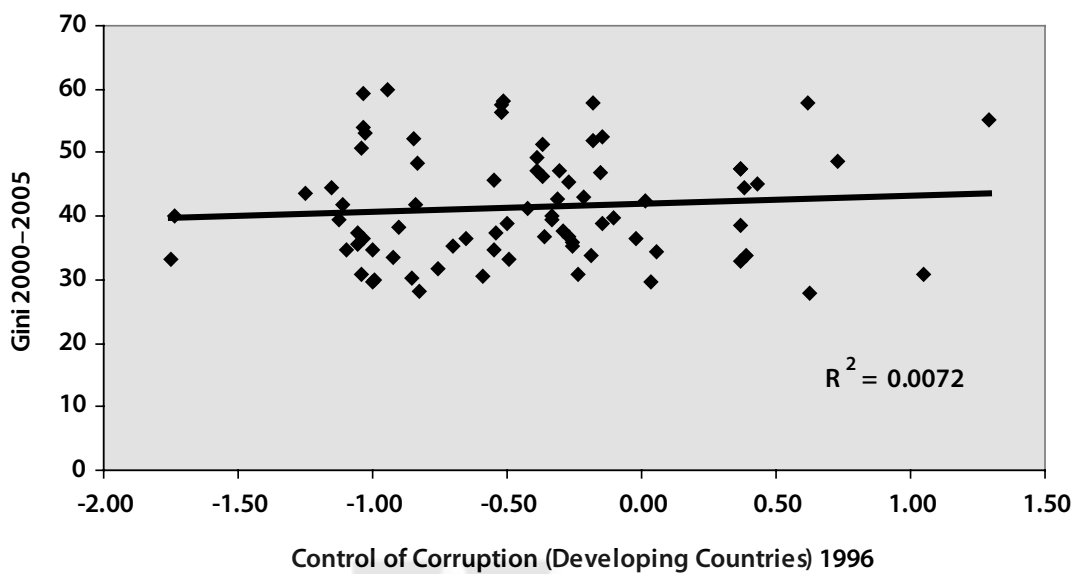
The danger of pooling all countries together is that we may be picking up arbitrary regional effects or structural differences between rich and poor countries along the lines of a possible Kuznets effect (Bourguignon 2004: 12–13). If the group of rich countries has, for whatever reason, better income distribution *and* better good governance scores for *unrelated* reasons, the pooled data will show a positive, but spurious relationship between good governance and better distribution. By separating developing from developed countries, we can reduce some of these problems, and when we do so, the relationship between good governance scores and distribution either disappears or takes the wrong sign.

Figure 3.8:  
Control of corruption and distribution, 2005 (all countries)



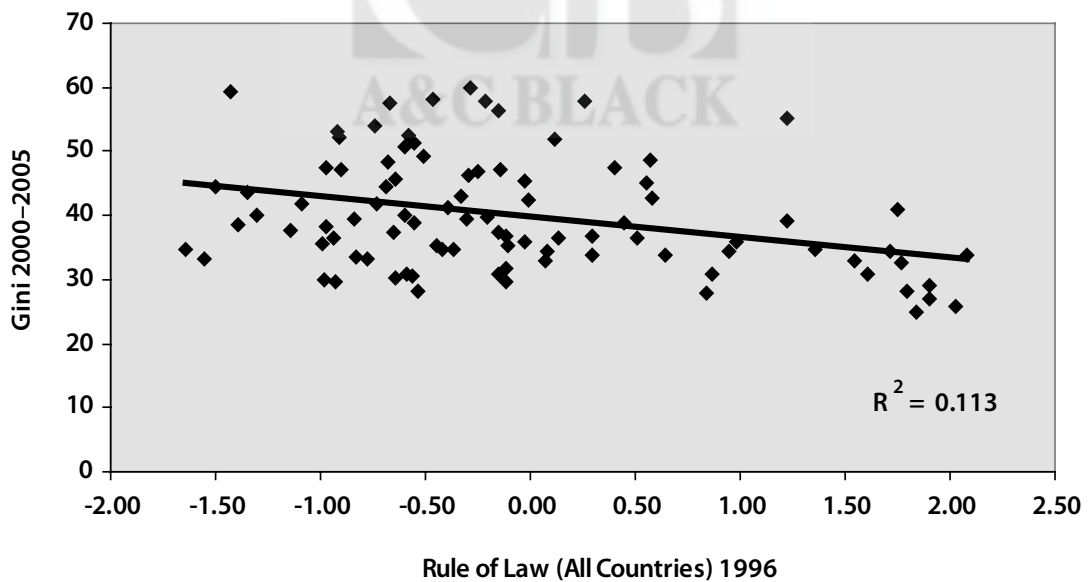
Sources: World Bank (2008a, 2008b)

Figure 3.9:  
**Control of corruption and distribution, 2005 (developing countries)**



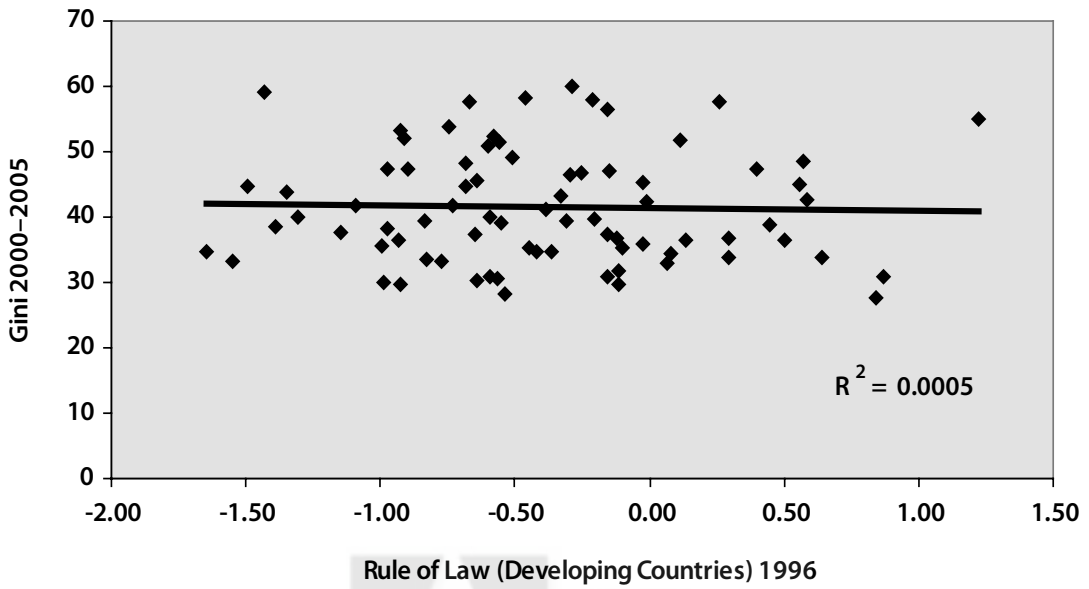
Sources: World Bank (2008a, 2008b)

Figure 3.10:  
**Rule of law and distribution, 2005 (all countries)**



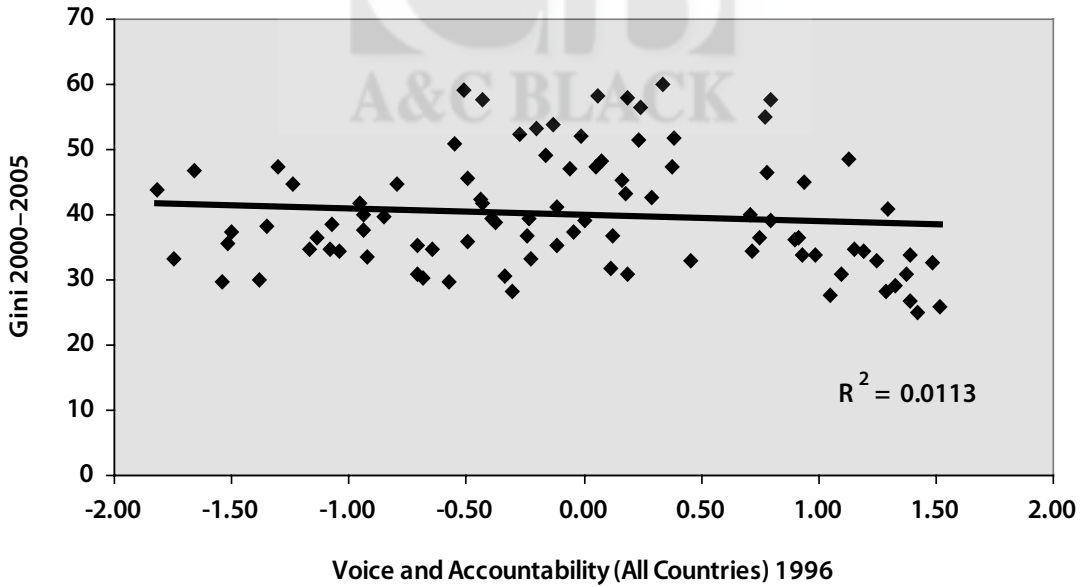
Sources: World Bank (2008a, 2008b)

Figure 3.11:  
Rule of law and distribution, 2005 (developing countries)



Sources: World Bank (2008a, 2008b)

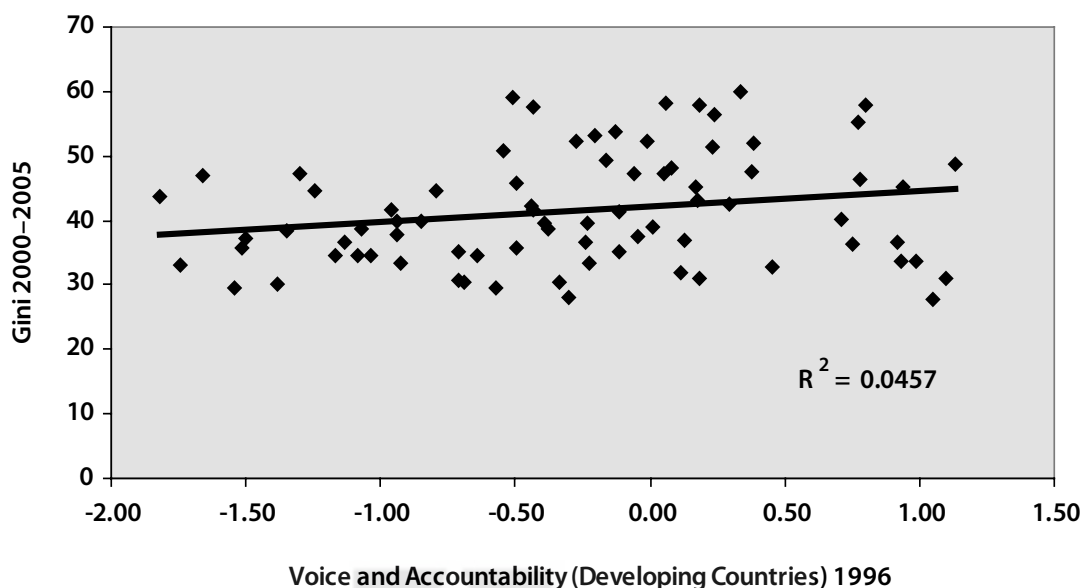
Figure 3.12:  
Voice and accountability and distribution, 2005 (all countries)



Sources: World Bank (2008a, 2008b)



Figure 3.13:

**Voice and accountability and distribution, 2005 (developing countries)**

Sources: World Bank (2008a, 2008b)

Missing from the empirical review above is an assessment of the effects of pro-poor spending programmes on distribution. We know that support for pro-poor spending has been an important part of aid-supported good governance policy packages (Figure 3.5), but there are no statistical indicators available for the extent or type of pro-poor spending programmes across developing countries. Pro-poor spending will have an obvious arithmetic effect on distribution, and therefore on poverty. But the immediate arithmetic effects of pro-poor spending programmes on distribution and poverty reduction are less important than the possible triggering effect they may have in changing the state-society relationship, as outlined in Figure 3.5. As pro-poor spending programmes are typically funded by aid, the arithmetic effect on its own is not sustainable because aid is not forever. The effect is only likely to be sustainable if there is a lasting impact on accountability, and if accountability, in turn, results in a sustainable improvement in income distribution, for instance through a sustainable reallocation of public spending towards pro-poor public goods. We do not know if pro-poor aid programmes have resulted in sustainable improvements in accountability, but there does not seem to be any obvious relationship between the accountability scores of developing countries and their overall Gini indices.

Given the type of data available to us, and the very limited time periods for which data are available, all we can say from the scatter points is that strong relationships between good governance capabilities and improvements in

income distribution do not appear to exist. More rigorous testing, using time series or panel data approaches, is required to examine if improvements in good governance in particular countries resulted in improvements in distribution in that country over time, but data for a much longer period would be required to investigate these possibilities further. For the 2000–2005 period income distribution data were available in many cases only for a single year. In the meantime, we can examine the possible theoretical linkages between governance capabilities and distribution, and in particular, the possible significance of the package of capabilities and priorities that the good governance approach identifies for distribution in developing countries.

### GOOD GOVERNANCE AND DISTRIBUTION: THEORETICAL LINKAGES

The linkage between the implementation of good governance reforms in poor countries and its effects on poverty through distribution depends on the types of implicit assumptions that we make about a series of background conditions. We combine the key policy features of the good governance reform package outlined in Figure 3.5 with the causal linkages between distribution and growth outlined in Figure 3.3 to show that the effects of good governance reforms depend on an underlying set of implicit assumptions. Making some of these assumptions explicit may help us to assess the plausibility of the claims made for poverty reduction through good governance reforms in specific country contexts.

Figure 3.14:

#### Optimistic scenario: Good governance and pro-poor distribution



Figure 3.14 shows the optimistic linkages that could justify good governance reforms as a way of achieving poverty reduction. In this optimistic scenario the pro-poor spending part of the package has a positive effect on investment in human capital and on the access of the poor to potential

investment resources. The growth-enhancing effects of these investments depend on the presence of employment opportunities that are simultaneously created for the new potential workers with better human capital, or less realistically, on the poor being able to borrow enough to create viable employment opportunities for themselves. This part of the story is therefore closely dependent on whether good governance reforms are likely to simultaneously accelerate the creation of employment opportunities through growth effects for the emerging capitalist sector.

The growth effects of the good governance reform agenda are theoretically plausible, but unlikely to be strong. We have discussed elsewhere that structural weaknesses of poor countries are likely to prevent them from significantly implementing good governance reforms. At the same time, growth in the modern sector is likely to be constrained by significant market failures unlikely to be addressed by the limited improvements in market efficiency achieved through good governance reforms (Khan 2007, 2008). If the growth of employment opportunities does not materialize, then this aspect of pro-poor spending will effectively have been a limited period of enhanced consumption for the poor. But in fact, since services like education and health for the poor will have been primarily provided by non-poor service providers, the main beneficiaries of pro-poor spending are likely to be the non-poor, with the poor acquiring some skills or consuming better health care for a while. Sustainable improvements in the incomes of the poor and therefore the effects on poverty through growth will only materialize if these investments in human capital are supplemented with a growth in job opportunities.

There is, however, a second and more direct effect on distribution and poverty through the effect of good governance reforms and support for pro-poor spending on the mobilization of the poor to hold governments to account. This is shown in the lower fork in Figure 3.14. The provision of pro-poor public goods through the state (initially funded by aid) together with good governance reforms that encourage accountability, attack corruption and strengthen the rule of law could induce the mobilization of the poor to demand effective delivery of what has been promised to them by law. If the response of the poor is to form sustainable and viable organizations (such as political parties or citizens groups) to ensure effective service delivery, these organizations could continue to operate to hold the state to account over time. If this happens, the redistributive effect could be permanent, not just limited to the period for which aid is available. This is indeed the chain of causation suggested in the policy linkages of the good governance reform package shown in Figure 3.5.

For the political redistribution effect to be positive in this case, without a negative impact on investment or investor confidence, we require some further

implicit assumptions. We have to assume that the distribution of power in society is such that once the poor mobilize to sustain the allocation of a greater share of public goods to the poor, or to demand redistributive programmes through the tax system, the rich will not be able to resist, and therefore will not try to resist. This assumption is necessary to ensure that adverse effects on investment do not follow. With these assumptions, the improvement in accountability—triggered by a combination of good governance reforms and the catalyst of aid-financed pro-poor spending—could result in a sustainable improvement in distribution. This would directly assist poverty reduction through the arithmetic effect shown in Figure 3.1, and may further assist poverty reduction through growth effects, if the conditions are appropriate for sustaining growth in the way suggested in Figure 3.14.

These political assumptions may be unrealistic in most developing countries. Pro-poor spending is typically targeted at the bottom 10 to 50 per cent of the population who are, by definition, the very poor, and mainly targeted to the population below the poverty line. This part of the population may be very numerous, but, typically, they are not collectively very powerful in developing countries. As a result, most of the redistributive conflicts in poor countries are between different fractions of the rich and the ‘intermediate classes’ (Khan 2005). The relatively small amounts of aid-funded pro-poor spending in poor countries are unlikely to change this fundamental distribution of power or result in an alternative set of powerful poor-led organizations emerging that can change the way governments are held to account.

The most optimistic of the realistic outcomes is that dominant political factions do not react adversely to protect their interests in the face of aid-financed pro-poor spending. The more pessimistic outcomes are that the politically dominant organizations of the not-so-poor will work out ways to capture much of the pro-poor spending. When this happens, this ‘rent seeking’ by intermediate class interests to capture more aid resources can quickly have adverse effects. Not only is delivery to the poor likely to be affected, but more seriously, the attention of the political elites is likely to be diverted towards sustaining the aid economy rather than being focused on the enhancement of productive capacity. A combination of adverse conditions can result in the focus on pro-poor spending having much more limited or even adverse effects on distribution and growth. The adverse scenario is shown in Figure 3.15. Here, pro-poor spending and good governance reforms fail to achieve growth accelerations, and on the political redistribution side, the main result is the diversion of mainstream patron-client factions into particular types of rent seeking. Unfortunately, this type of political response is all too common in developing countries.

Figure 3.15:

**Adverse scenario: Good governance and pro-poor distribution**

The effect of good governance reforms and pro-poor spending in many countries has been to induce an elaborate set of rent-seeking activities, beginning with the consultants and stakeholders who produce the Poverty Reduction Strategy Papers (PRSPs). As the pro-poor spending preferences of donors are well known, governments and stakeholders in developing countries have rapidly evolved skills in defining national priorities in line with activities likely to be funded. Ministries, departments and service providers of different types of pro-poor services have also frequently become aligned to absorbing and spending the inflow of resources. The poor can certainly benefit to some extent from immediate aid inflows, but it is questionable whether the type of sustainable pro-poor political realignment desired in the good governance framework has happened in any country receiving aid and good governance policy advice. The most pessimistic outcome is when the leading elites of the country begin to become dependent on pro-poor aid flows as sources of rents. The difficult and risky task of organizing the productive transformation of society can then take a back seat.

## CONCLUSIONS AND ALTERNATIVES

The good governance reform package is easy to support as a set of desirable objectives for developing countries to aspire to. There is considerable doubt as to whether this package is implementable to the extent that it can make a dent on the serious market failures that developing countries are subject to. There is therefore an argument that the good governance agenda may divert attention from the task of developing growth-enhancing governance capabilities in poor countries. On the other hand, there is the possibility that good governance reforms, particularly when bolstered by support for pro-poor spending as a way of improving government accountability, can have a direct effect on redistribution. Since poverty reduction is arithmetically

a function of growth and improvements in distribution, this effect of good governance could have a significant effect on poverty reduction.

The available data provides no evidence that good governance is associated with improvements in distribution. The weakness of the data has to be kept in mind, but there are also theoretical reasons to question the presence of strong relationships between good governance reforms and sustainable redistributive changes in favour of the poor. Given the weak political power of the poor and the implausibility of significant shifts in that power balance coming about as a result of pro-poor spending, it is more likely that good governance reforms will themselves be subject to new forms of rent seeking by elites. There is considerable anecdotal evidence from many developing countries that this is indeed most likely to happen. If so, any improvements in distribution are likely to be largely the result of aid-funded spending that is not likely to be sustainable over time. The reduction in poverty that is arithmetically achieved is therefore also likely to suffer if aid is eventually removed.

Our theoretical analysis of the relationship between growth and distribution suggests that sustainable improvements in distribution have to be consistent with a growth strategy, and our analysis of the arithmetic of poverty reduction reminds us that while improvements in distribution are important, the long-run reduction of poverty can only be assured by sustainable growth. Aligning redistributive agendas with the needs of growth strategies so that an acceptable mix of growth and distribution is achieved is obviously the only viable strategy. For this to be achieved, we may need to think outside the good governance box, not only as a growth strategy, but also as a redistribution strategy.

An alternative and pragmatic approach to thinking through the links between growth and distribution and the effects of poverty is suggested in Figure 3.16. A growth-enhancing governance strategy would focus on assisting developing countries to identify critical constraints to growth and develop the institutional capacities to address them. There may be many strategies, each prioritizing different sectors and market failures, each with different distributive implications. Keeping poverty reduction in mind means we should rule out growth strategies where the poor have to pay a significant price, even if only in the short term. The desirable mix of growth and distribution is obviously a political judgement and different political parties could well reach different judgements. The second part of the argument is very important. Whichever strategy a political leadership assesses as optimal is likely to have distributive implications that some powerful groups may resist. A successful growth strategy will therefore also have to give some attention to its feasibility. A strategy is only feasible if it can be implemented with achievable changes

Figure 3.16:

**A pragmatic approach to growth and distribution**

in the distribution of power. But all policies are likely to require some realignments of political power through the construction of appropriate new coalitions or the political weakening of specific distributive coalitions who would have opposed successful implementation of that specific growth strategy.

Clearly, the implicit realignment of political power in a pro-poor direction that good governance strategies attempt to achieve may be neither achievable nor, in any obvious way, linked to the implementation of a specific growth strategy. The challenge of poverty reduction is to make explicit the assumptions behind the linkages and to explore alternative strategies that require less demanding assumptions for their effective implementation.

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# Chapter 4

## The Emperor's New Suit: Global Poverty Estimates Reappraised<sup>1</sup>

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*The emperor marched in the procession under the beautiful canopy, and all who saw him in the street and out of the windows exclaimed: "Indeed, the emperor's new suit is incomparable! What a long train he has! How well it fits him!" Nobody wished to let others know he saw nothing, for then he would have been unfit for his office or too stupid. Never emperor's clothes were more admired.*

—*The Emperor's New Suit*, by Hans Christian Andersen (1837)  
English Translation: H. P. Paull (1872)

### WHY DOES IT MATTER?

It is widely agreed that how many poor people there are in the world, how poor they are, how their number has been changing over time and where they are to be found are important questions which must play a central role in assessing the state of the world. In light of the stated commitment of the international community and national governments, as enshrined in the Millennium Development Goals (MDGs), to “eradicate extreme poverty and hunger” and to halve, between 1990 and 2015, “the proportion of people whose income is less than one dollar a day”,<sup>3</sup> it is astonishing to learn how the questions raised above are currently answered. Conceptual arguments, as well as mounting empirical evidence, strongly suggest that the prevailing approaches to assessing global income poverty are logically unsound and may poorly reflect the empirical reality. Moreover, there has been little improvement over time in the methods employed. In this chapter, we will note some of the relevant arguments and evidence, bringing previous discussions up to date where required, and will make some suggestions as to how to improve the quality of global poverty estimates.

## A BRIEF HISTORY OF THE DEBATE

In recent years, understandings of poverty as a multi-dimensional concept, under-girded by the capability approach to well-being assessment, have rightly gained prominence. Nevertheless, income (and consumption) poverty remain at the core of public and institutional discussions of the subject, both for reasons of data limitations and because of the traditional centrality of this approach. For this reason, we will focus on such measures although, as we shall see, the capability approach has a role to play even in the assessment of income poverty, especially in defining an appropriate threshold for distinguishing the poor from the non-poor.

Although there is a long history of income poverty assessments in individual countries, the assessment of income poverty in regions comprised of multiple countries or indeed the world as a whole is fairly recent and begins in the late 1970s. In this early period, such assessments were undertaken by the Economic Commission for Latin America (ECLA) and by the World Bank (henceforth Bank), using rather different methodologies. Beginning in 1990, the Bank began the periodic production of global poverty estimates from household surveys. It has comprehensively revised and extended these estimates twice since then, modifying the details of its methods on each occasion but maintaining a general approach. We might say that the Bank has consistently maintained its concept of global consumption poverty since 1990 (and indeed in important respects, since 1979), even though it has varied the specific conception that it has concretely employed.<sup>4</sup>

Although some criticisms of the Bank's global poverty estimates were voiced from the early 1990s onwards (see e.g. Anand and Kanbur, 1991; Lipton, 1996; Yaqub, 1996), a number of additional criticisms were brought to public view in the current decade. Certain critics (e.g. Reddy and Pogge 2010) focused on the methodological limitations of the Bank's methods and suggested alternatives, but refrained from presenting estimates of their own. Others applied the Bank's method with small variations and produced very different empirical estimates (see, *inter alia*, Bhalla, 2002; Sala-i-Martin, 2006; Kakwani and Son, 2006; Asian Development Bank, 2008, etc.).<sup>5</sup> Nevertheless, the Bank's approach remains highly influential, and provides the reigning benchmark for discussions of the extent and trend of poverty globally, including in the United Nations system. Accordingly, we focus here on the methods employed by the Bank.

## THE BANK'S CONCEPT OF GLOBAL CONSUMPTION POVERTY

The Bank's method presupposes that PPPs (purchasing power parity conversion factors), reflect the relative purchasing power of currencies. These PPPs are defined as rates of exchange between national currencies and an abstract unit known as an international dollar (constrained to have an exchange rate of one with the currency of a numeraire country, the United States). The PPPs are purely spatial price indices defined only for a given base year. They are calculated using weights which reflect the pattern of consumption observed in the world in that year.

Once an International Poverty Line (IPL), defined as a certain number of international dollars per unit of time, is established, the PPPs can be used to identify the number of local currency units (LCUs) which is deemed equivalent to the IPL in each country in the base year in which the PPPs are defined, and this is the poverty line employed to determine the number of poor. To assess poverty in estimation years other than the base year it is necessary to shift the LCU poverty line from the base year to the estimation year (generally using the national consumer price index) to determine the number of LCUs in the estimation year, deemed equivalent to the base year poverty line.<sup>6</sup> In practice, the Bank has used an upper poverty line as well as a lower poverty line, and has recently moved towards using a broader range of poverty lines which include "subjective" poverty lines. However, we shall be concerned throughout with the lower poverty line described in various Bank documents as an "absolute" poverty line, and most widely referred to in public discussions and policy debates. When we refer to the IPL henceforth, it should be understood that we are referring to this line. Since the Bank's method involves specifying an international poverty line in abstract international dollar units and then converting it into the local currencies of countries, we may refer to its method as being a "money-metric" approach.

How is the IPL to be set? It is useful to distinguish between two general approaches in order to understand the Bank's method, which has varied in its details over time.

The first general approach specifies an IPL on the grounds of its ostensible *extrinsic* properties, such as its usefulness in public advocacy. For example, an IPL of \$1 has been argued to be useful from this standpoint. Such an IPL is likely to command wide recognition and be thought to be easily interpretable by those who refer to these poverty estimates. This has been suggested by various analysts to be an appealing feature of the poverty lines the Bank has applied (see e.g. Deaton, 2003).

The second approach specifies an IPL on the grounds of its apparent *intrinsic* properties, such as its interpretation in terms of the living standards that it permits. For example, an IPL may be argued to reflect the perceptions of poverty prevailing in poor countries (Chen and Ravallion, 2001; Ravallion, Chen and Sangraula, 2008). This approach has formally been referred to by the Bank in justifying its choices of IPLs. The Bank has consistently claimed that its IPLs are reflective of poverty lines created in developing countries themselves. In this respect, the Bank's concept of the IPL is empirical and inductive. In practice, the Bank has adopted shifting conceptions of what it means for an international poverty line to be "reflective" of those generated in developing countries and has not motivated these distinct individual conceptions very fully. Although the Bank claims to be pursuing an inductive approach based on the national poverty lines actually adopted in developing countries, it does not make explicit reference to a level of living which is achievable by adopting its IPL.

The poverty lines of developing countries must be converted into common units, and indeed the same unit—international dollars—within which the international poverty line is defined. The conversion should also preserve deemed purchasing power, in order for an international poverty line with the required interpretation, to be derived. Hence, PPPs must be used. As these PPPs change when the base year in which the IPL is defined is changed, the inductive exercise of IPL construction must be undertaken again each time such "updating" takes place. Accordingly, a new IPL is defined by the Bank on each occasion that new PPPs are calculated for a more recent base year. Since 1990, this inductive procedure has resulted in three distinct international poverty lines defined in the international dollars of distinct base years and each claimed to reflect the "perceptions of poverty prevailing in poor countries": \$1 (1985 PPP), \$1.08 (1993 PPP) and \$1.25 (2005 PPP).<sup>7</sup> It is important to understand that the use of PPPs implies that this international poverty line must have the same purchasing power interpretation in every country of the world, including the base country.

This having been said, the role of the base country is merely as a numeraire. Since the IPL is to be converted into local currency units of developing countries before being applied, and is itself ostensibly generated from national poverty lines applied in those countries, the role of the PPPs in the Bank's poverty assessment approach is not to convert between local currencies and the base country currency but to make possible comparisons among developing countries. It would suffice for that purpose to have PPPs between the developing countries themselves. However, this feature of the Bank's method is obscured by the choice of the United States as the base country.

Each “updating” of the base year leads to a change in the associated PPPs and the associated IPL. These changes generate an entirely new *edition* of poverty estimates—comprising new poverty estimates for each of the estimation years for which poverty is assessed by the Bank. In practice, each edition includes for a series of years from the early 1980s to the most recent year estimates of poverty in individual countries and regions. Thus, at present there are three distinct editions of such poverty estimates, each of which presents a distinct “space-time tableau”, offering an entirely different description of the level of poverty in each country at each moment in time (and thus the evolution of poverty over time). Bank officials have consistently claimed that the more recent edition is to be favoured (see e.g. Chen and Ravallion, 2001; Ravallion, Chen and Sangraula, 2008). The United Nations does not appear to have taken an explicit position on this issue, although it is hard to see how it can avoid doing so in its role of monitoring progress towards the first MDG of ‘eradicating poverty’.

#### THE RECENT REVISION

*At this moment the King, who had been for some time busily writing in his note-book, cackled out ‘Silence!’ and read out from his book, ‘Rule Forty-two. All persons more than a mile high to leave the court.’*  
*Everybody looked at Alice.*  
*‘I’m not a mile high,’ said Alice.*  
*‘You are,’ said the King.*  
*‘Nearly two miles high,’ added the Queen.*  
*‘Well, I shan’t go, at any rate,’ said Alice: ‘besides, that’s not a regular rule: you invented it just now.’*

—Alice’s Adventures in Wonderland, by Lewis Carroll (1865)

The Bank claims that the most recent edition of its poverty estimates, released in 2008, provides the most accurate estimates of poverty to date. Elsewhere, we have attempted to present systematic criticisms of the Bank’s concept of poverty, and argued that there are deep distortions inherent in its method, which diminish its credibility to a point that its estimates are not fit for use (see e.g. Reddy and Pogge, 2010; Pogge and Reddy, 2006; Reddy 2008a & 2008b). All of the points which we have made there in regard to previous editions of the Bank’s estimates also apply to this one. Since those criticisms are available in the public record, we shall not systematically attempt to reiterate all of those criticisms here, although we shall reiterate some of them. Rather,

we aim to examine closely the Bank's claims concerning its most recent edition of poverty estimates. Some of the new points we make apply incidentally to previous editions of the Bank's estimates while others apply only to this most recent edition.

*The Choice of the IPL:*

*Is it Reflective of Perceptions in Poor Countries?*

The Bank has repeatedly claimed that its inductive procedure is based on national poverty lines which reflect perceptions of poverty in poor countries. Moreover, this description of the procedure appears to have been widely accepted (see, for example, Besley and Burgess, 2003, among others). In the most authoritative description of the Bank's latest edition of poverty estimates (Ravallion, Chen and Sangraula, 2008), it is noted for the first time that most of these so-called "national" poverty lines are in fact compiled from World Bank Poverty Assessments (PAs) and other World Bank documents referring to countries, as well as Poverty Reduction Strategy Papers (PRSPs). Although PRSPs are nominally government documents, it is well known that they are very frequently and heavily drafted by World Bank and IMF staff members as well as consultants; thus, their contents, at most, reflect a negotiation between all of the national and international stakeholders involved.

This may not make the poverty lines quoted "biased toward the Bank's international poverty line", but it does raise a very serious concern about the claimed independence of these poverty lines (Ravallion, Chen and Sangraula, 2008: 8). The authors defend their use of PAs and PRSPs by arguing that "their aim is to use a poverty line appropriate" to the country. Indeed, they go so far as to argue that the poverty lines they use possess a "stronger claim to be national poverty lines than those used ... [in earlier Bank work], which were largely based on academic studies" (Ravallion, Chen and Sangraula, 2008: 7). Although they also argue that "the process of producing a PA entails (often extensive) consultation with the government [of a country]...including discussion is[sic] about the most appropriate poverty line", it is hardly clear whether we can conclude that these poverty lines "reflect prevailing notions of what poverty means in each country setting" (Ravallion, Chen and Sangraula, 2008).

The results of our own effort to catalogue which of the national poverty lines used are demonstrably independent, in the sense that the source cited is not a World Bank source or a PRSP shows that only 9 of the 87 sources cited have this feature.<sup>8</sup> Since two of those are produced by other multilateral

agencies rather than by a national government or agency only seven can be argued to have been both produced independently of the Bank and in a manner which provides some institutional assurance of being reflective of national perceptions. Only 10 of the sources are explicitly labelled as PRSPs, whereas 75 sources are World Bank documents unrelated to PRSPs. It is possible that the World Bank documents or PRSPs cited draw on an independent and previously established national poverty line. However, there is no way of knowing whether this is the case.

It can be seen that the “national” poverty lines, converted into common international dollar units, using general consumption PPPs, vary widely. In what sense then can these poverty lines be distilled into a single idea of the “perception of poverty” in developing countries? The Bank has argued in all of its money metric exercises since 1990 that the international poverty line it has chosen is one which is “typical” for the poorer countries in its sample. It claims that these poorer countries’ poverty lines fall in a relatively “flat” region of the curve representing the relationship between per capita consumption expenditure and the national poverty line “chosen” by the country. It is argued, in other words, that within a certain range of variation of per capita consumption of countries, poverty lines used in those countries do not, when expressed in international dollars, vary a great deal. However, in practice, the Bank’s method of identifying this “typical” poverty line has had a substantial *ad hoc* component. For example, for the edition of poverty estimates first produced in 1990, it was argued that the \$1 1985 PPP international poverty line was “typical” because it fell in the midst of a supposed *cluster of poverty lines* for low-income countries. This cluster broke down when subsequent PPPs were employed. In the edition of poverty estimates which came next, it was argued that the \$1.08 1993 PPP international poverty line was “typical” because it was *the median of the bottom ten poverty lines in the sample*—an entirely different criterion. In the latest edition of poverty estimates, the international poverty line is *the average of those in a reference group* defined by having a per capita consumption level beneath an apparently arbitrarily chosen ceiling (less than \$60 per month as judged by the Bank’s favoured PPPs)—yet a different criterion.

Why should one accept the Bank’s latest consumption ceiling-based approach (to restricting the set of national poverty lines used to generate the IPL)? It is evident that it is all-important how the ceiling (and thus the reference group) is chosen. As noted, in the latest exercise it is chosen, apparently arbitrarily, to be “the sampled countries with PCE [consumption expenditure] per capita less than \$60 [2005 PPP] per month, namely: Malawi, Mali, Ethiopia, Sierra Leone, Niger, Uganda, Gambia, Rwanda, Guinea-Bissau, Tanzania,



Tajikistan, Mozambique, Chad, Nepal, and Ghana”<sup>9</sup> It is interesting that this list of countries consists of only 15 out of the 87 in the original list (and 15 out of the 75 countries for which all of the data, including PCE and PPPs, needed to use them in the international poverty line construction exercise, were available). The remaining 72 of 87 (or 60 out of 75) play no role at all in the construction of the international poverty line which is deemed to reflect ‘absolute’ poverty. Thirteen of the 15 countries are sub-Saharan African countries and 12 of the 15 poverty lines which enter the reference group derive from World Bank documents or PRSPs. Many of the countries are also small. Does this set of poverty lines provide a robust basis for constructing an international poverty line “representative” of perceptions (or indeed realities) in poor countries?

It turns out that 12 more countries with incrementally higher per capita consumption expenditures could have been added to the reference group (corresponding to India’s PCE of \$84.24 at 2005 PPP or lower) without notably changing the mean poverty line of the reference group (and therefore the international poverty line defined according to the rule adopted)—although the mean fluctuates as additional countries are added.<sup>10</sup> The reference group can also be contracted to a degree without appreciably changing this mean. The “absolute” international poverty line is not “robust” to the choice of reference group. It is also by no means obvious that the average poverty line is the appropriate measure to be adopted when identifying the poverty line “typical” of a reference group, given the considerable variation between group members. For example, the leading alternative criterion for a representative poverty line, the median (used by the Bank itself in its earlier edition of poverty estimates) actually falls when the ceiling for defining reference group membership is expanded sufficiently and increases when it is contracted sufficiently.

Further, if we were to discard some or all of these poverty lines on the ground that they were not well constructed and not institutionally independent poverty lines, we might well get a rather different picture, given the wide variation in the poverty lines that is observed. In fact, it turns out that restricting the reference group to that very small number of countries for which the cited source of the poverty line is not a World Bank document or a PRSP leads to average and median poverty lines which are slightly lower than that adopted by the Bank.<sup>11</sup> Restricting this reference group further to countries for which the per capita consumption expenditure is lower than some ceiling leads to additional reductions in the mean and median. Taking a different approach, and including poverty lines from PRSPs along with those from independent national sources in the reference group leads to mean and median poverty lines which are substantially higher than that adopted by the Bank when there is no income restriction and very slightly lower when the same income ceiling

adopted by the Bank (\$60 2005 PPP) is imposed. However, it is clear that the mean and the median can be made to increase considerably *either* by decreasing or by increasing this ceiling. There seems no obvious path out of this forest of arbitrariness.

Do the national poverty lines used all reflect a sound method of construction? It is patently false that “Each of the national lines meets ‘industry standards’ in its construction, in that it uses a food bundle that attains standard nutritional requirements means by prevailing diets and it includes an allowance for non-food spending” (Ravallion, 2008). This statement contradicts the contents of the final column in Table A1 of Ravallion, Chen and Sangraula (2008) and the slightly more modest statement in that paper that “In 80% of cases, some version of the ‘cost of basic needs’ method has been used”. The claim that the national poverty lines used in constructing the IPL reflect “industry standards” cannot be sustained when it is restricted to those countries which actually enter the Bank’s reference group. Only 7 of the 15 countries used in constructing the “absolute” 2005 \$1.25 IPL possess poverty lines which are based on the cost of meeting nutritional or other needs.<sup>12</sup> It is probable that even in these cases the specifics of the methods employed considerably differed. The median of a reference group consisting of these countries alone is only slightly higher than the Bank’s IPL and the mean is only slightly lower but this cannot be taken as especially informative, given the small number of countries used and the questionable premises already noted.

There would be substantial uncertainty as to what international poverty line to apply even if one accepted the Bank’s general approach. The proportion of the world’s poor who live in different regions as well as the overall trend of poverty are substantially dependent on the international poverty line chosen, even when the PPPs used to translate the IPL are held fixed. The trend of poverty and the regional composition are related since the rate of poverty reduction in different regions differs (see e.g. Minoiu and Reddy, 2008).

What are the implications of different choices of IPL within the Bank’s approach? Suppose we consider the lowest of the IPLs which may be identified as an absolute poverty line “reflective” of poverty lines in poor countries as being \$25 (2005 PPP) per month and the highest as being \$50 (2005 PPP) per month (both contrasting with the Bank’s currently favoured actual “absolute” poverty line of \$38 (2005 PPP) per month). The corresponding estimates of global poverty and its composition across regions<sup>13</sup> show that the poverty trend is less favourable when the upper poverty line we adopt is applied (indeed it is even less so when the Bank’s own preferred “upper” poverty line of \$76 (2005 PPP) per month or \$2.50 per day is chosen). According to the lower poverty line, the goal of halving the share of the developing country population living

in poverty has already been achieved but according to the higher poverty line there is still a considerable distance to go. Much more strikingly, the regional composition shifts dramatically. When the higher poverty line is used, the proportion of the world's poor living in South Asia is seen to be much greater than in sub-Saharan Africa. When the lower poverty line is used, the proportion living in sub-Saharan Africa is somewhat higher in 2005 (although not in 1990). Perhaps most surprisingly, the proportion of the world's population of poor persons living in East Asia is more than a quarter even in 2005, when the higher poverty line is used.

*Does the Revision of the IPL Raise or Lower It in Countries, and Why Does It Matter?*

There cannot be a single answer to the question of whether the poverty line corresponding to the current edition of the World Bank's global poverty estimates is higher or lower than that corresponding to an earlier edition. This is because each of these IPLs is defined in terms of a distinct abstract unit, and these are not directly comparable. There is no general rate of exchange between PPP dollars of different base years.<sup>14</sup>

Can the question be answered at all? It *can* be answered from the standpoint that ultimately matters: whether it leads to a higher or a lower poverty line at the point of application—in each individual country. If the change of IPL were to lead to a uniform increase or uniform decrease in these poverty lines expressed in local currency units we might be able to come to an unambiguous conclusion about the impact of the revision. Unfortunately, the change in the base year is accompanied by a twisting and not merely a rescaling of the “PPP vector”: the PPPs of some countries go up and the PPPs of other countries go down. These changes might be justified if it were thought that the relative purchasing power of distinct currencies over the commodities needed to avoid poverty had changed in the interval between the base years. However, as discussed in Reddy and Pogge (2010), there are reasons to think that there might be distortions of these relative purchasing power assessments arising from the method of calculation of PPPs, especially due to the entry into the calculation of “irrelevant commodities” and “irrelevant countries”.

There is a straightforward method of assessing empirically whether the changes in PPPs between base years are ones which can be justified on the ground of changes in the relative cost of purchasing relevant commodities. Since the PPPs are defined in units of distinct base years a temporal price index must be used within each country in order to convert the purchasing

power represented by an IPL, once it is translated into local currency units, into units comparable with another IPL. The national consumer price index of a country may be used as the temporal price index within each country, and indeed is what is used by the Bank itself when converting its IPL from the base year to a given estimation year.

From the results of such a country-by-country comparison of the relative magnitudes of the international poverty lines of the three different base years employed by the Bank since 1990 (once expressed in the local currency units of a common year) it may be observed that each shift in base year led to an increase in the poverty line in certain countries and a decrease in other countries beyond that which would be *warranted* on the ground of changes in the national consumer price index.<sup>15</sup> Since the direction as well as level of the change varies considerably, it is not possible to speak of the international poverty line either having increased or decreased. Rather, it decreased in some places and increased in others. For example, the 1993 local currency value of the IPL was 45 per cent of its 2005 value in the Gambia, 59 per cent of its 2005 value in China and 63 per cent of its 2005 value in Indonesia, but it was 115 per cent of its 2005 value in Thailand, 120 per cent of its 2005 value in Egypt and 122 per cent of its 2005 value in Gabon (as judged by applying the local CPI). This is reflected in the fact that the distribution of estimated poverty across regions and countries in the world as well as its absolute level in individual regions and countries has changed greatly between the last edition and the current edition of the Bank's poverty estimates, just as they changed between the preceding two editions.<sup>16</sup> It should be mentioned here that for the exercise reported here we employed the PPP for "actual individual consumption" (as opposed to the PPP for "individual consumption expenditure by households") in order to use a comprehensive measure of the cost of those items ultimately consumed by individuals and one which corresponds most closely to the PPP concept used in earlier base years.<sup>17</sup> However, qualitatively similar, and numerically even more dramatic, results would have been arrived at by using the slightly narrower PPP concept employed by the Bank in generating its 2005 base year poverty estimates.

It might be argued that the new international poverty line need not be required to be consistent in any way with the earlier international poverty line and in particular may be allowed to reflect an entirely different level of purchasing power over commodities in each local context. This position involves treating each edition of international poverty estimates as being utterly incommensurate with what precedes or follows it. That position is intellectually consistent, but it is neither the position which is adopted by the Bank itself, nor is it easy to justify. We take these two points up in turn.

The Bank has made efforts when introducing each new edition of poverty estimates to argue that the new poverty line is in some sense “consistent” with the old one, despite elsewhere noting the incommensurability of its different IPLs. When introducing its 1993 PPP IPL it argued that such consistency existed because the new global headcount of the poor was similar to the old, resulting from the 1985 PPP IPL. Reddy and Pogge (2010) argued that this argument was spurious. More recently, Ravallion, Chen and Sangraula (2008), devote extensive energy to presenting such an argument for consistency—this time centred on the claim that the “mean poverty line in 2005 PPP amongst countries with poverty lines around the \$1.08 figure at 1993 PPP” is not greatly different from the new poverty line that they choose.<sup>18</sup> However, our exercise demonstrates that change in PPPs generates broadly discrepant values of the IPL, as expressed in constant value local currency units, in countries themselves. No specific choice of IPLs can remedy the resulting discrepancies in the local values of IPLs defined in distinct base years.

If the perspective is taken that each edition of the Bank’s poverty estimates is not comparable with other editions then a different problem arises. Which edition should be chosen? Is there a ground on which to pick one over another, or do they simply present alternative reasonable portraits of the world? The fact that the different editions differ in their assessment of the extent of poverty in the world, as well as in their portrait of the composition of poverty across regions and in its trend over time, should provide grounds for serious concern. Indeed, the Bank’s own explicitly articulated position is that the latest edition of its poverty estimates is always to be favoured over the previous ones. Typically, it has argued that this is the case on grounds that the later editions employ “higher quality” price data in the construction of PPPs, resulting from more extensive coverage of countries in price surveys as well as better approaches to the collection of price data and their synthesis into aggregate indices.

However, the argument that later editions should always be preferred is hard to sustain. We may address this issue from two perspectives, respectively that of pure time preference and that of data quality. The perspective of pure time preference suggests that the latest edition is always to be preferred simply because it employs a base year nearest to the present. A base year nearer to the present presumably better reflects relative prices which currently prevail across countries than does a base year that is earlier. This might provide an argument for this base year to be chosen when assessing poverty in the most recent estimation year. However, as noted above when a base year is changed this results in an entirely new edition of poverty estimates—a space-time tableau used to assess poverty trends. A similar argument can be

used symmetrically to suggest that the PPPs which most closely corresponds to some earlier year for which poverty estimates are produced (e.g. 1981) should be preferred for the purpose of estimating poverty in *that* year. However, this would mean using poverty lines with different real values in any given year. In view of our finding that the ratios of the real values of different IPLs vary greatly by country, this would be true regardless of the nominal value of the IPL chosen in the different base years. Choosing a different IPL could fix the problem in one country but not in all countries simultaneously. In any case, the freedom to adjust the IPL cannot be fully exploited since, in the Bank's method, the IPL chosen is itself allegedly a consequence of the PPPs used. It is evident that the perspective of pure time preference has little to offer in adjudicating the dispute between base years.

What about the perspective of data quality? According to this perspective the latest base year is to be preferred not because it is closer to the present but because of the superior quality of the data entering into a construction of PPPs. It has been argued (see Heston, 2008; International Comparison Program, 2008; Klasen, 2008; Ravallion, Chen and Sangraula, 2008) that the 2005 PPPs are to be preferred from this standpoint. It is suggested that this is the case of the general consumption PPPs which have been most recently employed by the Bank, and that it will be even more true of the poverty specific PPPs which are currently being constructed. This argument can and should be treated on its merits. There are some reasons to argue that not every change that has been brought about constitutes an improvement for the purpose at hand. For example, the better measurement of government consumption and services in these surveys may be rather irrelevant for the exercise of poverty assessment (see Reddy, 2008b). Whether or not these changes bring about more sound poverty assessment overall (or indeed even less sound assessment) will depend on the extent to which they help to correct other distortions which existed, which is difficult to assess in individual countries, let alone globally.

Equally importantly, the argument that a later survey possesses better data quality cannot be viewed as decisive over the argument that an earlier price survey is more appropriate for assessing poverty in earlier years. It might be argued that a price survey from an intermediate year is to be viewed as superior from the standpoint that it distorts relative prices less in more years than would the choice of a base year at an extreme end of the time period covered, even though it brings about some distortion in all years. However, such an approach cannot resolve the far more serious problem (discussed in Reddy, 2008b) that each new price survey by the International Comparison Program (ICP) demands, given the Bank's approach, an unhappy choice. Either the new set of PPPs must be adopted, thus introducing an entirely new IPL which

is possibly higher in some countries and lower in others than can be justified on the basis of national consumer price index change (and which also reflects relative prices that are still more distant from the earliest estimation year than was the previous IPL) or the old set of PPPs must be retained. In the latter case, the interpretation of the IPL associated with that earlier set of PPPs in terms of current money is lost diminishing the supposed value of the IPL in public advocacy and debate, and now reflecting relative prices which are distinct from those prevailing in the most recent estimation year. There is no way to resolve this conundrum within the Bank's approach.

If the method used by the Bank to choose an IPL which was "representative" of national poverty lines in poor countries was held constant, along with the national poverty lines used,<sup>19</sup> then a change in the base year (and associated PPPs and IPL) could be seen as having two effects. The first effect is to change the relative magnitude attached to individual national poverty lines when they are converted into a common unit. This may affect what is determined to be representative. The second effect is potentially to bring about increases or decreases in the real value (i.e. after adjustment for changes in the consumer price index) of the LCU poverty lines applied in individual countries. Both of these effects will bring about a shift in the relative proportions of the poor in different countries. It has been argued elsewhere (most especially in Reddy and Pogge, 2010; Pogge and Reddy, 2006) that such shifts bring about instability in poverty estimates, on a scale which severely undermines the aim of credibly monitoring poverty in the world.

### *Are the PPPs Used of the Appropriate Type?*

A major issue addressed in previous criticisms of the Bank's global poverty estimates is that of whether the PPPs being used are the appropriate ones. The issue goes beyond the choice of base year, and concerns the question of whether the commodities for which relative prices are being collected are receiving appropriate weights when overall PPPs based on these prices are calculated. Such appropriateness is to be judged in regard to the purpose of the exercise, viz. poverty assessment. There are also other issues of calculation such as the entry of irrelevant countries into the generation of bilateral price comparisons.

One persistent misunderstanding of previous criticisms is that the critics have argued that "it would be better to use the PPP for food consumption alone" in the construction of an IPL, on the ground that food is an important component in the avoidance of poverty. It was argued in Reddy and Pogge (2010) and Pogge and Reddy (2006) that the fact that PPPs for food and other

tradable necessities are higher than are PPPs for general consumption is merely illustrative of the distortions which arise due to the inappropriate use of the latter. It was not suggested that an appropriate substitute would be the PPP for food. PPPs for food were found to be significantly higher than those for general consumption due in part to the tendency for international price equalization to take place for tradable goods. Thus, for a fixed international dollar poverty line, the local currency equivalents would be higher if a more appropriate PPP, giving greater weight to such necessities were to have been employed.

If the IPL is allowed to change according to the PPPs used, then the effect of a shift of these PPPs is in principle indeterminate, since whether and to what extent such a shift raises or lowers local each individual poverty lines used to calculate the IPL as well as how the shift affects its national currency equivalents will both be relevant. It was shown in Reddy and Pogge (2010), however, that for the previous (1993) base year a shift from general consumption PPPs to food PPPs led to an increase in LCU equivalents of the revised IPL even if the international poverty line was recalculated, using the rule for such calculation then in place. Ravallion, Chen and Sangraula present a food poverty line based IPL of \$22.74 2005 PPP per month (or \$0.96 2005 PPP per day) based on their current method for calculating the IPL from national poverty lines. This represents a reduction of 40 per cent in the nominal 2005 international dollar value of the IPL. However, for the countries included in the Bank's national poverty line database, food PPPs are on average found to be about 70 per cent higher than general consumption PPPs.<sup>20</sup> This is also true of the median ratio of food to general consumption PPPs in these countries. The population weighted mean ratio of food PPPs to general consumption PPPs suggests that food PPPs are on average about 60 per cent higher than general consumption PPPs even after taking population into account. It can thus be concluded that the use of food PPPs would lead to substantially higher (perhaps 30 per cent higher, similarly to the finding in Reddy and Pogge, 2010) poverty lines and poverty estimates in poor countries, even if the IPL is recalculated using the Bank's own method. If the IPL is not recalculated the increase in poverty lines is even more dramatic and is much higher than for previous base years. The implication of these findings is that the use of more realistic PPPs (even while preserving other aspects of the Bank's approach) might lead to much higher estimates of the amount of poverty in the world (and therefore also lower rates of poverty reduction)—see e.g. Pogge (2008), Reddy (2008b) and Subramanian (2009). For the general consumption PPPs used to calculate the ratios to which we refer we employed PPPs for Actual Individual Consumption in order to use a broad consumption concept most closely corresponding to those PPPs



employed in earlier base years, and to have a resulting basis for comparison with earlier analyses. If PPPs for “individual consumption expenditure by households” were used instead as the general consumption PPPs with which to compare food PPPs then the magnitudes of the ratios would look slightly less dramatic but the comparison would lead to rather similar conclusions. Since the concept of “actual individual consumption” encompasses all of those forms of consumption which are “closely linked to the welfare of the population” (United Nations, 1992, II.A.2.b.65) it may be the more appropriate PPP concept to employ in generating as well as translating the IPL, especially if some or all of the forms of consumption it includes are also imputed to households when assessing household consumption on the basis of surveys. The prevailing definitions of consumption in surveys appear to vary widely. The concept of “individual consumption expenditure by households” is what the Bank appears actually to employ in generating its 2005 base year poverty estimates, although no justification has been provided for this choice.

Since the initial circulation of Reddy and Pogge (2010) in 2002, the Bank has moved, in conjunction with the ICP, the secretariat of which it now hosts, to begin to develop so-called poverty specific PPPs. These PPPs are not yet being employed in the Bank’s poverty estimates. Although these PPPs may mitigate the problems we identify, they are unlikely to eliminate them, for reasons discussed, *inter alia*, in Pogge and Reddy (2006), Reddy and Pogge (2010) and Reddy (2008b). Most centrally, the calculation of such PPPs cannot be undertaken in a fully valid manner since the prices paid by the poor cannot be identified without determining who the poor are, the tasks to which the poverty specific PPP are meant to be applied! The use of iterative algorithms and other approaches only obscures rather than overcomes this unavoidable fact. The recent effort by the Asian Development Bank (2008) to present estimates based on such poverty specific PPPs, although a creditable effort, is dogged by such problems.

### *The Substantive Interpretation of the IPL*

We have pointed out in other work (see Pogge and Reddy, 2006; Reddy and Pogge, 2010) that the Bank fails to apply an IPL which has the substantive significance that it ought to have if all the PPPs employed succeeded in capturing purchasing power equivalence in the required sense. In particular, the IPLs fail to capture the costs of meeting the most basic requirements of human life in the base country (the United States) which is an inescapable logical requirement of combining the definition of the IPL in purchasing power equivalence

terms with a substantive interpretation of the IPL in terms of the requirements of escaping “absolute” poverty.

On the other hand, it seems the interpretation that PPPs capture purchasing power equivalence in the relevant sense in each and every case can be relaxed without altogether undermining the Bank’s approach. In particular, PPPs between developed countries and developing countries can be “inaccurate” without reducing the “accuracy” of the bank’s poverty assessment exercise under certain circumstances. If the international dollar (constrained to have purchasing power parity with the US dollar) is viewed only as a numeraire, any exchange rate between that unit and the currencies of the developing countries involved in the exercise can be adopted as long as the PPPs applied between developing countries do capture purchasing power equivalence in the relevant sense. If so, the Bank’s approach may succeed in inductively deriving an IPL from national poverty lines of developing countries which has the required interpretative significance within such countries. Is there any reason to believe that the Bank’s PPPs do this at a minimum?

We have already presented evidence that the Bank’s IPLs have substantially shifting real local currency values in individual developing countries and that the direction and magnitude of the shifts varies from country to country. The extent to which real purchasing power is truly captured by the local currency equivalents of international dollars (and therefore of IPLs) from different base years has also been shifting. If the CPIs of countries are trusted to capture real equivalence over time then it cannot be argued that the PPPs that the Bank uses capture real purchasing power across countries appropriately in one base year without arguing that it did so *inappropriately* in the other base years. Putting it baldly, the PPPs of a given base year together with the CPIs of countries tell one story about the relative purchasing power of local currencies across country-years. This story typically contradicts that told by the PPPs of another base year, and by a very wide margin. Which of the three witnesses is the liar?

The appropriate rates of exchange of currencies which capture real purchasing power equivalence is, of course, only one element of the poverty lines used within the Bank’s approach. It is also necessary to ensure that the poverty lines employed possess a required substantive interpretation in terms of the command over the commodities necessary to escape deprivation. This idea is implicit in the description of the Bank’s IPL as “absolute”. Here, it can only be pointed out that in practice the IPL appears to be higher than the poverty lines used in some countries and lower than those in others, although it is quite possible that none of the poverty lines constructed are truly adequate for capturing the costs of avoiding absolute deprivations. Interestingly, the ECLA’s nutritionally based poverty line was roughly equal in many countries

to the poverty line adopted by the World Bank in 1979 (Ahluwalia, Carter and Chenery, 1979) which was designed to be comparable with the Indian poverty line (and which, in turn, has been compared to the lower poverty line of the Bank in subsequent base years—see e.g. the discussion in Ravallion, Chen and Sangraula, 2008). Since then, the Bank’s “absolute” poverty estimates appear to have become much lower than those of the ECLA (see Reddy, 2008a; Chen and Ravallion, 2008: Table 7). The substantive validity of the Bank’s IPL can only properly be assessed by comparing it against well-constructed national poverty lines which capture the requirements of avoiding absolute consumption poverty understood in an appropriately common way.

Reddy and Pogge (2010) recognized that regional differences within countries in the costs of avoiding absolute deprivations could be substantial, and that the Bank’s approach often seemed inadequately to take account of this. This is an issue not merely of the absence of relative price indices, but of a failure to account for the presence of different challenges to living an adequate life in different contexts. Recently, the possibility that urban poverty has been severely underestimated has been interestingly discussed (see e.g. Bapat, 2009 and Satterthwaite, 2004). This possibility gains special significance in light of the fact the world has been rapidly urbanizing.

An approach to poverty assessment which is grounded in a concern for basic human rights must also include an insistence that the criteria used for identifying who is poor must have something to do with the substance of human experience. The approach taken cannot be that this exercise is essentially arbitrary (on which claim, see e.g. Deaton, 2003).<sup>21</sup>

#### IS THERE AN ALTERNATIVE?

It has been argued elsewhere (see Pogge and Reddy, 2006; Reddy, 2004; Reddy, 2008b; Reddy and Pogge, 2010; Reddy, Visaria and Asali, 2008) that there is an alternative to the Bank’s money metric approach to global consumption poverty estimation. This alternative is simple. It is that the construction of national poverty lines and the design of surveys should be appropriately coordinated through appropriate international standards (on the lines of those applied by the United Nations to the creation of the System of National Accounts) so as to reflect a common meaning of the poverty lines constructed in terms of the resource requirements of essential human achievements. One way of interpreting these achievements is in terms of consumption-dependent basic capabilities. The range of relevant basic capabilities considered should be made comprehensive enough to possess a persuasive interpretation in terms of adequacy of life, while being sufficiently narrowly drawn to command broad

agreement. Such an approach must include a detailed approach to assessing the resources needed to fulfil individual elementary capabilities (such as the freedom to be adequately nourished) while going beyond individual capabilities to consider their joint resource requirements.

With coordination of poverty line construction (and survey design) across countries, the need for the use of PPPs in poverty assessment would altogether disappear. The coordination of poverty assessment methods would generate “bottom-up” inherent comparability, over time as well as space.<sup>22</sup> Such an approach can be made fully consistent with the need to take adequate account of relevant features of local context, since it does not insist on uniformity at the level of detailed application, but only uniformity at the level of interpretation. In spirit, this approach is in line with Amartya Sen’s suggestion that one may think of poverty as a concept which is absolute in the space of capabilities and relative in the space of commodities. Of course, there can be reasonable disagreement about appropriate methods to apply in poverty assessment. It is desirable for this reason that poverty lines should be constructed in a transparent and participatory process involving national poverty commissions or the like (see e.g. Atkinson, 2006).<sup>23</sup> Such national processes should operate according to common guidelines so as to ensure international comparability but seek to apply these in an adequately tailored and context-sensitive manner so as to ensure relevance. An approach of this kind combines interpretative attractiveness, analytical clarity and empirical applicability. It is grounded in the insistence that consumption or income poverty assessment must be based on a conception of basic requirements of human beings. In doing so, it does not in any way take away from the need to supplement such information with other direct information about deprivations experienced. Although a capability-based approach to income poverty assessment seeks to set poverty lines in accordance with a conception of the relevant basic capabilities it cannot substitute for other capability-based information.

#### THE NEED FOR INSTITUTIONAL REFORMS

There is an urgent need for institutional reforms in the collection and dissemination of global poverty statistics. The current approach is centralized, obscurantist and untransparent. The resources expended on the ICP and other activities which are at least in part intended to support the Bank’s global poverty estimates (for example, the recent effort to collect information for the construction of poverty specific PPPs) are enormous. The costs of the present approach may well outstrip those of implementing an alternative. More pertinently, the value of having better estimates of poverty is incontestable. Such

estimates are used every day by UN agencies, as well as by national governments and non-governmental organizations, and enter influentially into public debates. Improving the quality of these statistics is in the global public interest.

An alternative to the current slipshod approach can only be developed over the intermediate term. In the short run, there is little alternative but to rely less on the existing money-metric global poverty estimates and to place greater weight on other sources of information.

In the intermediate and long term, the United Nations system should return to a position of public leadership in statistical data collection and interpretation. It can begin by convening a high-level multi-stakeholder committee to begin a transparent and participatory review of current global poverty statistics and to examine proposed alternatives.

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## NOTES

- 1 Subsequent versions of this chapter, correcting errors or extending the argument, will be made available on [www.socialanalysis.org](http://www.socialanalysis.org).
- 2 I would like to thank Zeest Haider for valuable research assistance, Thomas Pogge and an anonymous referee for helpful comments, and Jomo K.S. and S. Subramanian for their sustained encouragement. Finally, I would like to dedicate this chapter to Michael Ward (without at all implicating him in its contents). He was a thoughtful and honest independent statistician, a distinguished international civil servant and a fine human being.
- 3 <http://mdgs.un.org/unsd/mdg/Host.aspx?Content=Indicators/OfficialList.htm>. This may be the first time that the concept of eradication has been understood in terms of halving. See Pogge (2004) for related discussion.
- 4 For the idea of a general concept comprising many distinct conceptions, see e.g. Rawls (1999).
- 5 Some of the criticisms made (in particular concerning the PPPs employed) appear to have led to an extensive subsequent work programme on the part of the International Comparison Program and the World Bank to remedy the perceived drawbacks of existing approaches, although the critics whose work has spurred the revisions do not appear to have been consulted about them.
- 6 A subsidiary issue is that of how to deal with the fact that surveys may not have been undertaken in the estimation year itself. This problem is resolved by the Bank by “moving” the nearest survey data to the estimation year by applying the growth rate of real consumption per capita from the national income and product accounts to the nearest surveys in order to increase or decrease the consumption imputed to individuals.
- 7 There have been four such IPLs if one includes that employed by Ahluwalia, Carter and Chenery (1979).
- 8 The detailed results of this exercise can be found in Reddy (2009).
- 9 It turns out that the median poverty line in the full sample is just under \$61 per month although the mean “is higher at about \$2.90 per day” (or just under \$90 per month). However, the level of the median is not provided as a justification for the threshold chosen.
- 10 It would have increased from \$37.98 to \$38.24. By restricting the threshold a little more, even this increase could largely be avoided. The detailed results of this exercise can be found in Reddy (2009).
- 11 The detailed results of this exercise can be found in Reddy (2009).
- 12 These are the countries in the group which are marked in Table A1 of Ravallion, Chen and Sangraula (2008), as possessing poverty lines constructed according to the “cost of basic needs” method. Including countries classified as adopting the “food energy intake” method (none of the countries) or the “same food basket” method does not add to this number.
- 13 The detailed results of this exercise can be found in Reddy (2009).
- 14 For this reason, those who have written about the concept of ‘PPP inflation’ are making a methodological error (see e.g. Bhalla, 2002).
- 15 The detailed results of this exercise can be found in Reddy (2009).
- 16 Compare, for example, the regional results reported in Chen and Ravallion (2008) and in Chen and Ravallion (2001). Reddy and Pogge (2010) and Pogge and Reddy (2006) undertake a comparison of the two previous base years’ poverty estimates for specific regions and countries.



- 17 The concept of 'final national consumption' employed by the ICP to calculate the consumption PPP it reported for the 1985 base year included 'Collective Consumption of Government' as well as items consumed by individuals, including education and health care, which are often provided by government. The basis for the construction of the 1993 PPPs employed by the Bank has never been made transparent, although the PPPs used were referred to as "consumption PPPs", suggesting that, as per then prevailing ICP practice, they reflected the cost of all consumption items, whether or not privately financed. The 2005 ICP results appear for the first time to report separately PPPs for "actual individual consumption" (inclusive of such government provided private consumption) and for the narrower concept of "individual consumption expenditure by households" (which excludes it). However, even the broader PPP concept now excludes "collective consumption expenditure by government" and appears thus not to be strictly comparable in its coverage of items with those employed in earlier base years.
- 18 This is of course still different from arguing that using the same operation which they used to generate the IPL in the preceding base year, namely to take the median of the poverty lines of the poorest ten countries, gives rise to the same answer. Repeating that operation in fact leads to a slightly higher poverty line.
- 19 Neither is the case.
- 20 The detailed results of this exercise can be found in Reddy (2009).
- 21 Ahluwalia, Carter and Chenery (1979) wrote, "The first step in measuring the scale of poverty is to establish a common poverty line to be applied across countries. It is self-evident that such a definition is necessarily arbitrary". This explicit position is one which finds echoes in subsequent writings on global poverty estimates from the Bank, although it is sometimes combined with the contradictory claim that the poverty lines used represent an absolutist understanding of poverty.
- 22 Such an approach of periodically reconstructing a poverty line while maintaining an invariant capability-based interpretation of the poverty line could have avoided some of the recent poverty assessment related controversies seen in India. See Reddy (2007), Subramanian (2009) as well as the contributions of Deaton and Kozel (2005).
- 23 For an interesting recent application of a participatory approach to building poverty lines anchored in a concept of basic human requirements, see Human Resources and Skills Development Canada (2008).

# Chapter 5

## Poverty Reduction in China and India: Policy Implications of Recent Trends

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JAYATI GHOSH

China and India are generally regarded as the two large countries in the developing world that are the “success stories” of globalization. This success has been defined by the high and sustained rates of growth of aggregate and per capita national income; and the substantial reduction in income poverty. Further, both China and India are seen as heralding a major shift in the international division of labour through changes in their own output and employment patterns: thus, China is typically described as becoming the “workshop” or “factory” of the world through the expansion of manufacturing production, and India as becoming the “office” of the world, in particular because of its ability to take advantage of IT-enabled services offshoring. These results, in turn, are viewed as the consequences of a combination of a “prudent” yet extensive programme of global economic integration and domestic deregulation, as well as sound macroeconomic management. Consequently, the presumed success of these two countries has been used to argue the case for globalization and to indicate the potential benefits that other developing countries can reap. The importance of these two countries spills over into discussions of international inequality as well.<sup>1</sup> This makes the comparison of the extent of poverty reduction in India and China, and the possible causes of the revealed patterns, of particular current relevance.

It should be noted, however, that despite the similarity of the current international hype about their future economic prospects and also despite their obvious differences, both China and India face rather similar economic problems at present, especially with respect to the sustainability of growth and the emerging inequalities. These concerns actually predate the current global financial crisis and the associated slowdown in many economies, which have obviously also affected growth prospects in China and India. In both countries, the strategy of development had delivered relatively high income growth without commensurate increases in employment, especially in the

organized sector; the bulk of new employment has been in lower productivity activities under uncertain and often oppressive conditions. In both countries, the growth has been associated with sharp increases in spatial and vertical inequalities, greater fragility of incomes among marginalized groups and adverse shifts in certain human development indicators. In both countries, 2004 marked a shift in declared political priorities towards more inclusive growth, with varying effects.

This chapter is organized as follows. In the remainder of this introductory section, the important economic differences and similarities of the two countries are briefly outlined. The second section deals with trends in growth and poverty reduction in China, considering the trends in poverty and the factors determining these trends, while the third section deals with the same issues for India. The final section draws some conclusions and considers the prospects for poverty reduction in both countries in the context of the still unfolding global financial crisis and economic slowdown.

#### DIFFERENCES AND SIMILARITIES

The two economies are fundamentally dissimilar in some important ways. Although they have superficial attributes in common, such as large populations covering substantial geographical areas, regional diversity, relatively high rates of growth over the recent period and so on, the institutional conditions in the two economies remain very different. India was a traditional “mixed” developing economy with significant private sector participation (including a large private corporate sector) from Independence onwards, and even during the “dirigiste” period, the emphasis was predominantly on the regulation of private capital. Indeed, one of the problems of the so-called “planned economy” in India was the inability of the state to make the private sector behave in ways that fit in with the plan allocations of the state, leading to mismatches between production and private demand as well as periodic macroeconomic imbalances. The neo-liberal reforms undertaken during the phase of globalization have further expanded the scope for private activity and reduced regulation. Essentially, in India, macroeconomic policies have occurred in contexts similar to those in other capitalist economies, where involuntary unemployment is rampant and fiscal and monetary measures have to be used to stimulate effective demand. The inability to undertake land reforms or other strategies that would have involved substantial redistribution of assets not only meant that wealth and income inequalities continued to be very high, but also affected the ability of the Indian state to

undertake economic policies that would be perceived as going against the interests of the landed and other elites.

However, China, by contrast, has had a very different economic structure for most of this period, where the basic elements of a command economy have been much more in evidence. The most important difference to be noted here is that after the revolution of 1949, the Chinese state embarked on comprehensive and sweeping land reforms that dramatically altered asset distribution in the country and changed the political economic landscape that determined subsequent policies. While land relations have undergone numerous changes since then, from collectivization to more dependence on independent small holder peasants, the dominance of landlordism was clearly eliminated. Greater equality of access to land and other assets also affected the conditions of access to other forms of wealth and avenues for economic and social mobility. They also meant that economic policies had very different results than they would have had in a more economically unequal context.

Even after the quite sweeping economic reforms that have taken place since 1979, state control over macroeconomic balances remains substantial. Furthermore, because of the significance of state-owned enterprises and the township and village enterprises (TVEs) in total production, the ability of the state to influence aggregate demand does not depend only on fiscal policy in terms of purely budgetary measures, since many “off-budget” expenditures can be increased or reduced. Further, monetary policy, as it is generally understood in capitalist economies, has very little meaning in China where private financial activity is limited and state-owned banks still overwhelmingly dominate the provision of credit. Rather, macroeconomic adjustment has typically taken the form of “administrative measures”, such as moving to slow down an overheating economy through a squeeze on credit provision to regional and provincial governments and public and private corporations ensured through administrative fiat, rather than the use of traditional macroeconomic measures. It is true that the Chinese economy is currently in a phase of transition to one where more traditional “capitalist macroeconomics” is applicable. But the Chinese government’s continuing ability to quickly ensure macroeconomic correction when required is because that transition is still limited.

The control over the domestic economy in China has been most significant in the financial sector. In India, the financial sector was typical of the “mixed economy”, and even bank nationalization did not lead to comprehensive government control over the financial system; in any case, financial liberalization over the 1990s has involved progressive deregulation and further loss of control over financial allocations by the state in India. But the financial system in China still remains heavily under the control of the state, despite recent

liberalization and the sale of some shares to foreign investors. Four major public sector banks handle the bulk of transactions in the economy, and over the past several decades, the Chinese authorities have essentially used control over the consequent financial flows to regulate the volume of credit (and thus manage the economic cycle) as well as direct credit to priority sectors. Off-budget official finance (called “fund-raising” by firms) has accounted for more than half the capital formation in China even in recent years, and that, together with direct budgetary appropriations, has determined nearly two-thirds of the level of aggregate investment.

Another difference has been becoming less evident in recent years—the dramatically high rate of GDP growth in China compared to the more moderate expansion in India. The Chinese economy has grown at an average annual rate of 9.8 per cent for two and a half decades, while India’s economy has grown at around 5–6 per cent per year over the same period. Chinese growth has been relatively volatile around this trend, reflecting stop-go cycles of state response to inflation through aggregate credit management. The Indian economy broke from its average post-Independence annual rate of around 3 per cent growth to achieve annual rates of more than 5 per cent from the early 1980s. It is only in the four-year period before the global economic crisis started in late 2008 that the Indian economy grew at rates in excess of 8.5 per cent per annum, coming close to the Chinese average.

The higher growth in China has essentially occurred because of the much higher rate of investment in China. The investment rate in China (investment as a share of GDP) has fluctuated between 35 and 45 per cent over the past 25 years, compared to 20–26 per cent in India (very recently increasing to 35 per cent). Aggregate incremental capital-output ratios (ICORs) have been around the same in both economies. Within this, there is the critical role of infrastructure investment, which has averaged 19 per cent of GDP in China compared to 2 per cent in India from the early 1990s.<sup>2</sup> It is sometimes argued that China can afford to have such a high investment rate because it has attracted so much foreign direct investment (FDI), and is the second largest recipient of FDI in the world at present. But FDI has accounted for only 3–5 per cent of GDP in China since 1990, and at its peak was still only 8 per cent. In the period 2000–07, FDI accounted for only 6 per cent of domestic investment. In fact, in recent times, the inflow of capital has not added to the domestic investment rate at all, macroeconomically speaking, but has essentially led to the further accumulation of international reserves, which have been increasing by more than \$100 billion per year.

In terms of economic diversification and structural change, China has followed what could be described as the classic industrialization pattern, moving

from primary to manufacturing activities in the past 25 years. The manufacturing sector has doubled its share of the workforce and tripled its share of output, which, given the size of the Chinese economy and population, has increasingly made China “the workshop of the world”.<sup>3</sup> In India, by contrast, the move has been mainly from agriculture to services in terms of share of output, with no substantial increase in manufacturing, while the structure of employment has been stubbornly resistant to change. The share of the primary sector in national income has fallen from 60 per cent in the early 1950s to 25 per cent in 2001–03, but the share of the primary sector in employment continues to be more than 60 per cent, indicating a worrying persistence of low productivity employment for most of the labour force. The higher rates of investment in India over the past two decades have not generated more expansion of industry in terms of share of GDP, but have instead been associated with an apparent explosion in services, that catch-all sector of varying components. The recent expansion of employment in some services in India has been at both the high and low value added ends of services sub-sectors, reflecting both some dynamism and some increase in “refugee” low productivity employment.

Another major difference relates to trade policy and trade patterns. Chinese export growth has been much more rapid, involving aggressive increases in world market shares. This export growth has largely been based on relocative capital which has been attracted not only by cheap labour, but also by excellent and heavily subsidized infrastructure, resulting from the high rate of infrastructure investment. In addition, the Chinese state provision of basic goods in terms of housing, food and cheap transport facilities for registered urban dwellers has played an important role in reducing labour costs for employers. In India, cheap labour has been available because of low absolute wages rather than public provision and underwriting of labour costs, and infrastructure development has been minimal. So it is not surprising that it has not really been an attractive location for export-oriented investment, its rate of export growth has been much lower, and exports were not an engine of growth until relatively recently. This difference was also reflected in employment patterns: in China until the late 1990s, the rapid export growth generated employment which constituted a net addition to domestic employment, since until its WTO accession, China had undertaken much less trade liberalization than most other developing countries. This is why manufacturing employment grew so rapidly in China until the mid-1990s, because it was not counterbalanced by major losses of employment due to the effects of displacement of domestic industry because of import competition. This is unlike the case in India, where increases in export employment were outweighed by employment losses especially in small enterprises because of import competition.

In terms of inequality, the recent pattern of growth has been disequalizing in both economies. In China, the spatial inequalities—across regions—have been the sharpest. In India, vertical inequalities and the rural-urban divide have become much more marked. In China there have recently been some top-down measures to reduce inequality as a response to this, for example through changes in tax rates, greater public investment in western and interior regions and improved social security benefits. In India, it is political change, through electoral verdicts, that has forced greater attention to redressing inequalities, though the process is still very incipient.

In terms of future prospects, surprisingly both economies end up with very similar issues despite these major differences. There are clear questions of the sustainability of the current pattern of economic expansion in China, since it is based on a high export-high accumulation model which requires constantly increasing shares of world markets and very high investment rates. This model is obviously directly challenged by the global economic and financial crisis starting from mid-2008, which very quickly had adverse effects on manufacturing exports. Similarly, the hope in some policy quarters in India—that IT-enabled services would become the engine of growth for the entire economy—raises questions of sustainability, quite apart from questions about whether it will be enough to transform India's huge labour force into higher productivity activities. The most important current problems in the two economies are also rather similar—the agrarian crisis and the need to generate more employment. These are in addition to the need to deal with the effects of the global financial crisis, which have been evident in the real economies of both countries and especially marked in India's financial sector. In both economies, public intervention in the social sectors has been neglected until recently. In both countries, therefore, despite the very different institutional conditions and other dissimilarities, even in the way that recent economic trends have played out, the crucial policy concern is still that of ensuring sustainable productive employment generation for the majority of the labour force.

#### POVERTY REDUCTION IN CHINA

China's spectacular growth performance—an annual trend rate of growth of real GDP of just under 10 per cent for slightly longer than the past quarter century—is primarily a reflection of the high investment rates that have characterized the economy over this period. Capital formation as a share of GDP has been very high by international standards, varying between 32 and

44 per cent of GDP. The most recent data indicate that the investment rate in China is above 45 per cent currently. This implies rates of domestic savings which are exceptional by international standards, particularly for an economy at China's level of per capita income. Such high and rising rates of domestic savings in turn imply a suppression of domestic consumption out of incremental income, which reflects a combination of the sheer rapidity of the growth itself, as well as growing income inequalities, especially in the functional distribution of income.

### *Increasing inequalities*

Obviously, the extent to which high aggregate income growth translates into poverty reduction depends upon income distribution. The available evidence clearly suggests worsening inequality in China, as shown in Table 5.1.

Table 5.1:  
Gini coefficients for consumption distribution in China

	1978	1988	1997	2002
<b>National</b>	0.30	0.38	0.34	0.45
<b>Rural</b>	0.21	0.30	0.34	0.38
<b>Urban</b>	0.16	0.23	0.29	0.34

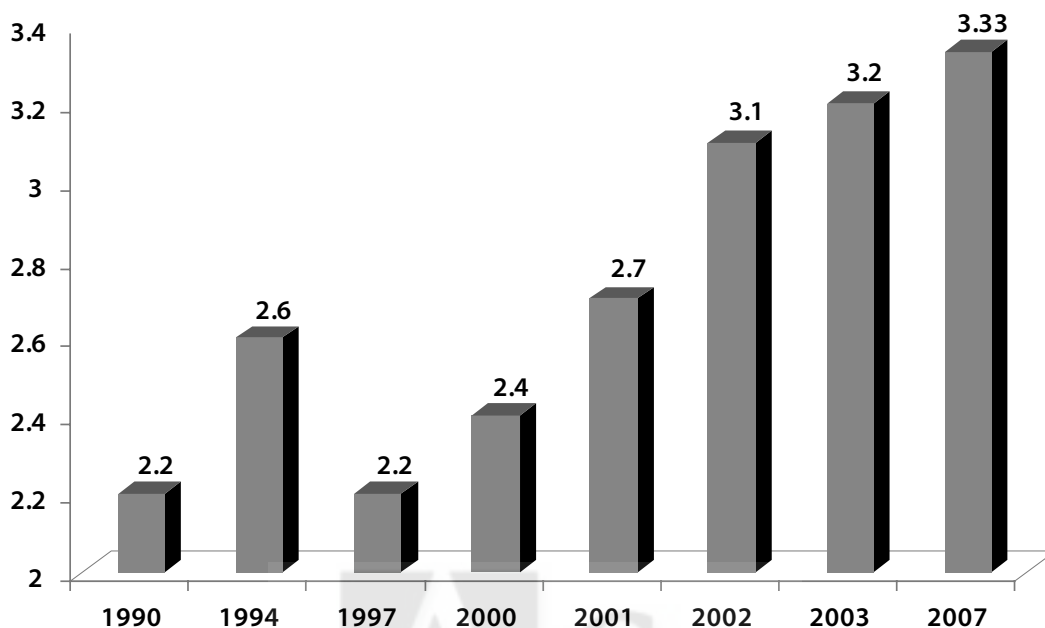
Source: UNDP China Human Development Report (2005)

It is evident that in the post-reform period (as indeed was also true before) the national Gini has been generally higher than both rural and urban Ginis, indicating that rural-urban differences have dominated economic inequality. It is estimated that 42 per cent of the aggregate income inequality in China in 2002 was because of the rural-urban gap. But this could actually be an underestimate because registered urban residents enjoy a variety of subsidies, ranging from free medical care and subsidized schooling to pensions, insurance and living allowances, which are not available to most rural residents. Some analysts (Kanbur and Zhang 2003, Khan and Riskin 2004, Li and Yue 2004) have argued that if these subsidies are taken into account, the ratio of urban to rural incomes may exceed four times. Others note that living costs tend to be lower in rural areas, which would somewhat counterbalance this, and that including migrant incomes in urban areas would reduce the gap further.

Official statistics suggest that the rural-urban income gap increased significantly between 1990 and 2007, as indicated in Figure 5.1, and that the most significant differentiation occurred after 1998. The reduction in the rural-urban



Figure 5.1:  
Ratio of urban to rural per capita income in China



Source: CASS and UNDP (2005, 2008)

income gap in 1997 (which, incidentally, was also associated with a significant reduction in rural poverty in that period) was very much a result of the shift in terms of trade—higher agricultural prices play a direct role in reducing inequalities because of the equitable distribution of agricultural land already noted. While rural-urban income inequalities are high, the rate of urbanization is high and has increased recently in China: the share of the urban population increased from 18 per cent in 1978 to 26.4 per cent in 1990, 36.2 per cent in 2000 and 45 per cent in 2007 (*China Statistical Abstract 2008*).

Table 5.1 also shows that the urban Gini was substantially lower than both the rural and national Ginis at the start of the period under consideration, but increased much more sharply, indicating that the process of differentiation was especially rapid in urban China. Indeed, urban inequality is likely to be even higher in the most recent period for two reasons: the survey data generally do not include rural-urban migrants without residence permits (*hukou*) who constitute the poorest section of urban population, and the consumption of the richest households tends to be underestimated in such household surveys. Rural-urban migrants—currently estimated to be between 150 and 200 million—play a huge role in the urban economy even though they are not included in the calculations of urban income distribution or poverty, except in some recent (and exceptional) estimates. Riskin (2006) suggests

that including them would increase the estimates for urban inequality and poverty, but lower the national-level Gini coefficient.

Khan and Riskin (2005) suggest that income inequality rose sharply in China between 1988 and 1995, due to increases in inter-regional inequality; slow and disequalizing rural income growth; regressive transfers to households and reduced transfers from rich to poor provinces; slow growth in employment and inadequate social protection for retrenched workers; and restrictions on migration along with discriminatory treatment of migrants. While these trends continued after 1995, a number of developments, including greater rural-urban migration and policy changes aimed at reducing regional inequality by promoting investment in western and interior provinces, ensuring the spread of wage employment in rural areas and provision of better social security benefits, appear to have reversed the tendency towards increased inequality.

Between 1995 and 2002, income inequality in both rural and urban China declined as a result of a decline in regional inequality, improvement in the distribution of both farm and wage incomes, housing reform and the reform of public finance. But the Gini coefficient for China as a whole did not change between the two years because of a rise in the already high gap between average urban and rural incomes. In fact, the increase in the rural-urban income gap would have been even larger, but for a substantial decline in rural population after 1995, when the absolute size of the rural population peaked.

In rural areas, regional inequalities account for a large part of overall inequality. The slower pace of income growth in the central and western regions, compared to the eastern coastal region, has widened the income gaps among regions. This, in turn, is related to structural changes in output and employment: the coastal regions have provided more opportunities for non-agricultural employment and income. By contrast, the distribution of agricultural income across regions has been more equal, reflecting the greater quality of control over agricultural land.

Urban inequalities are also affected by regional differences, one manifestation of which is in wage disparities across provinces. In 2003, the highest average provincial wage was 2.6 times the lowest (UNDP 2005). But vertical income inequalities in urban China have also increased sharply, particularly after 1992, when market-oriented reforms were accelerated in the southern and eastern parts of the country.

In contrast to income inequalities, estimates of wealth inequality suggest stability or even a slight decrease. One major reason for this in rural China has been the relatively equitable distribution of land, which has tended to offset other inequalities. While this has been a major factor in poverty

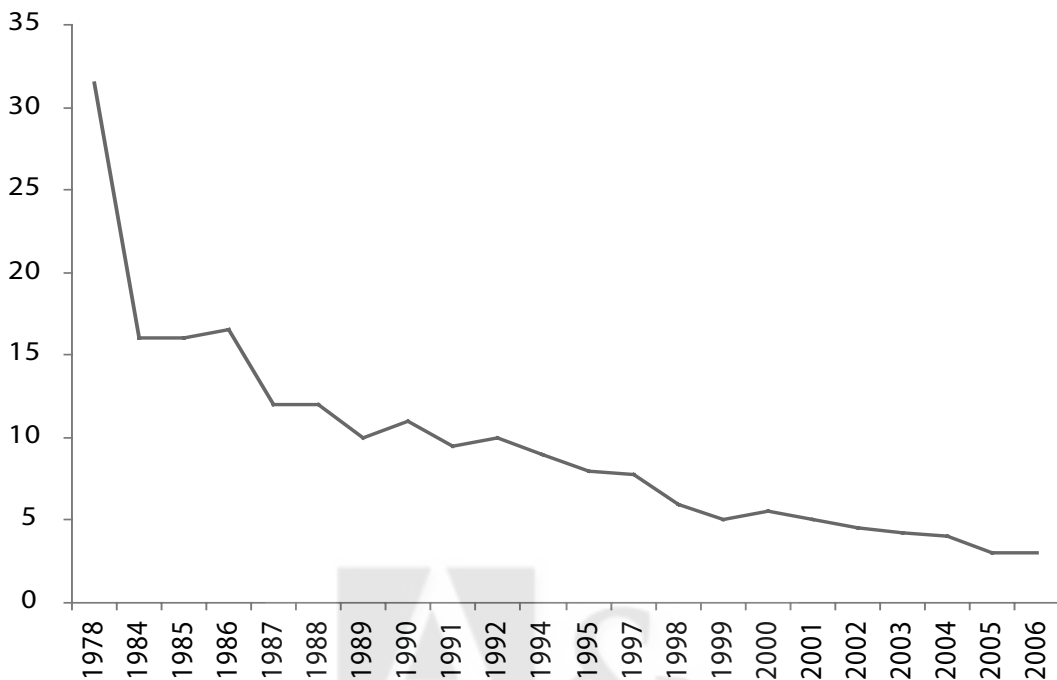
reduction as well, as discussed below, there are some areas of concern relating to recent tendencies in displacement of the peasantry as land is converted for non-agricultural uses. Provincial and local governments in some of the more economically dynamic provinces have played a growing role in this. In urban China too, access to residential housing has been an important equalizing factor, as the policy of providing title deeds to residents of public housing has led to a more equal wealth distribution. However, actual wealth inequality is likely to be higher because of the underestimation of other forms of wealth among the rich.

### *Changes in Poverty Incidence*

The Chinese case has often been cited as an example of how rapid aggregate growth and industrialization are associated with poverty reduction. Yet, in fact, it illustrates quite sharply the crucial importance of growth in agricultural incomes for poverty reduction, in a context of relatively equitable distribution of land. What is striking about the post-reform Chinese experience with growth and its effects on poverty reduction is that while Chinese growth was consistently high across time (except in 1989), poverty reduction was concentrated in particular periods. The relationship between poverty reduction and growth has varied over time, being strong at the beginning of the “reform” period and somewhat weaker afterwards.

Figure 5.2 indicates changes over time in the incidence of rural poverty, based on official Chinese estimates. These are likely to underestimate poverty for several reasons. Unlike for most other developing countries, Chinese poverty estimates are based on income rather than expenditure data, while the latter typically show greater absolute poverty. Chen and Wang (2001), using an expenditure-based line, found that the proportion of rural poor was 25 per cent in 1999, compared to only around 5 per cent according to the official income-based estimate. Similarly, Hussain (2003) found that for 1998 survey data, estimates of urban poverty increased by two and a half times (from 14.7 million to 37.1 million) using expenditure data rather than income data.

Figure 5.2:  
Rural poverty ratio in China



Source: CASS and UNDP (2005, 2008)

Further, the poverty line is derived on the basis of a basket of foods, and before 1998, food grains dominated this bundle, amounting to 88 per cent of the total value of the bundle, even though they were only 70 per cent of the total food expenditure of poor households. This gave disproportionate significance to grain prices, which have been kept from increasing as rapidly as other food prices (Riskin 2004). In any case, the official poverty line has not kept pace with consumer price inflation, and it has been estimated (Park and Wang 2001) that in 2000, this caused the poverty line to be at least 13 per cent lower than in the mid-1980s. Subsequently, too, the increase in prices of many essential goods has not been adequately captured by the official poverty line. Non-food items have been given only 17 per cent weight after 1998, even though they account for between 27 and 49 per cent of the total expenditure of poor households across the various provinces.

Even so, it can be seen that much of the reduction in rural poverty was concentrated in two relatively brief periods: the first five years of the reform period, 1979–1984; and the period 1995–1997. (This has also been noted by Bouche and Riskin 2004, Riskin, 2004.) This change had much to do with the nature of the growth, which began by being centred on agriculture and the rural economy where most of the poor lived, and then shifted to the industrialization of the coastal cities where the poor were less evident except as migrants.

The first period 1979–1984 was when policies of economic reform focused on the countryside. Over these years, the “reorganization” and dismantling of the rural people’s communes led to the parcelling out of land to households on a broadly egalitarian basis, with peasant households being given control over the use of land without having the right to sell. Instead of the previous “grain first” policy, farmers were encouraged to diversify production to more high-value produce. At the same time, crop prices were raised 30 per cent over the five-year period. In addition, supplies of agricultural inputs, including chemical fertilizers, were sharply increased and provided to farmers at subsidized rates. All this led to significant increases in agricultural incomes, and this translated directly into reduced poverty because most cultivators were net sellers of both cash crops and food grains.

The second period of substantial decline in rural poverty occurred in the middle years of the 1990s. Once again, this was driven by the inter-sectoral terms of trade: specifically, a steep rise in farm purchase prices, especially of food grain, which doubled in the middle of the decade. After a long time, rural per capita incomes increased faster in real terms than urban incomes, leading to the decline in the urban-rural income gap described in Figure 5.1. It is evident that in the period 1994–1997, poverty reduction proved to be highly income-elastic, as a 21 per cent increase in rural income was accompanied by a 40 per cent decrease in rural poverty (Chen and Wang 2001). However, this was essentially because of the forces driving the increase in rural incomes (higher returns to cultivation) in a context of egalitarian land distribution and the dominant role of agriculture in rural livelihood.

Hu and Chang (2004) have argued that notwithstanding China’s substantial poverty reduction since 1978, the pace of poverty reduction has decelerated and new forms of poverty have arisen. This is explained by the authors in terms of two factors: the deteriorating quality of growth in terms of its employment generation potential and increased inequality. Trends in poverty have also been closely linked with trends in employment (Sengupta and Ghosh 2005). In rural areas, slow growth in the agricultural sector resulted in almost stagnant rural employment after the mid-1990s. Rising unemployment was a major driver of urban poverty in the post-1985 phase, a scenario further strengthened by migrants from rural areas.

It is known that reforms in China impacted adversely on urban poverty by generating unemployment through restructuring the state-owned sector in a context where the social security system was weak or absent. Bouche and Riskin (2004) argue that urban poverty is closely associated with inability to find work, and that the increase in urban unemployment, as a result of market-oriented reforms and withdrawal of financial support for ailing state

enterprises, had been a prime cause of the increase in urban poverty. Prior to restructuring the state-owned enterprises (SOEs), there was no great variation in urban poverty among regions due to guaranteed employment and the ubiquitous urban welfare system. This regional pattern changed when market-oriented reforms restructured the SOEs, led to significant closure of SOEs, privatization and large-scale lay-offs of workers, and also weakened the urban social welfare system. Changes in the regional distribution of urban poverty were highly correlated with the original structure of industry and with regional economic growth. The incidence of urban poverty tends to be higher in those regions where the heavy industries set up during the era of central planning were concentrated, and lower in the towns and cities of the south-eastern coast which have experienced more dynamic growth.

Moreover, financial stringency also limited the poverty reduction effort. In China, most poverty reduction programmes financed by the central government and by international donors required counterpart funds from local governments, but most local governments in poor counties faced severe budgetary constraints. As a result, a report by the State Auditing Bureau indicated that 370 out of 592 poor counties had not provided any counterpart funds from 1997 to 1999. The problem was similar in urban areas, since many city and town governments lacked the fiscal resources to provide counterpart funds for financing the new unemployment, pension and medical insurance systems.

Despite high growth, the most important and urgent economic problem China has been facing is unemployment. According to Yu Yongding, in every year of the early 2000s, 10 million more were thrown onto the job market. In addition, more than 5 million redundant workers from former state-owned enterprises have sought re-employment. Finally, there are hundreds of millions of migrant farmers constantly moving around the country seeking jobs. As a result, even the high rate of growth in China, if not accompanied by structural and other changes ensuring more job creation, cannot meet the pressure for jobs. For example, in 2003, with a 9.1 per cent aggregate GDP growth rate, 8 million jobs were created, but even this was inadequate given the continuously growing “backlog” of labour force increases and reduced demand for labour in many traditional activities including agriculture.

While income poverty in rural areas has been reduced by rural-urban migration, in urban areas, most of the poor are recent migrants, who tend to be much worse off than other urban residents. For example, Hussain (2003) found that the incidence of poverty among migrants was 50 per cent higher than among non-migrant urban residents in 1998. Migrant workers typically experience high turnover of employment, and also suffer from the disadvantages of being excluded from the formal labour market, public housing and

access to health services and schooling for children at low cost that urban residents are entitled to.<sup>4</sup> In addition, the urban poor who have urban resident status are also entitled to a subsistence allowance, the incidence of which has spread in recent years. In the early 1980s, the official urban poverty rate was about 2 per cent and the total urban poor population was 4 million. This decreased to about one million in 1989 according to official estimates, though unofficial estimates are much higher. For example, according to a 1994 survey by the Social Survey Centre of the People's University, there were then about 50 million impoverished urban residents (Hong Dayong 1997). The number would be even larger if the estimate were to be based on the actual place of residence of individuals, rather than their registered permanent residence. More recent estimates (ILO 2006) also suggest much higher actual poverty in urban areas than indicated by official estimates. This is essentially because of the gap in incomes and benefits accruing to migrants compared to "full status" or registered urban residents. Recently the Chinese government has announced some measures to provide some facilities to unregistered migrants, but the impact of these on urban poverty has yet to be assessed.

### *Indicators of Human Poverty in China*

Income poverty is now widely accepted to be an inadequate indicator of actual conditions of life, as it does not capture various other forms of deprivation, including the fulfilment of various social and economic rights. The concept of human poverty is wider, and many of its elements are worth considering in this context.

The most important alternative indicator to consider is that of nutrition and calorie intake. Income poverty estimates in both China and India are implicitly based on calorie intake, since the poverty lines are derived from the income/consumption expenditure level associated with the ability to purchase sufficient food to meet some specified calorie intake. In both countries, the per capita requirements on which the original poverty lines were based were 2400 kcal per day in rural areas and 2100 kcal per day in urban areas, and these lines have been subsequently adjusted with consumer price indices.

The extent of "food poverty" has generally been higher than income poverty, and the divergence has grown over time. Using household survey data from rural areas of 19 provinces in 1995, Zhu (2001) found that while official poverty incidence was only 5 per cent, the proportion of the rural population with calorie intake below 2400 kcal per day was 28 per cent, and that receiving less than 2100 kcal per day was 17 per cent. Using a much lower norm

does obviously reduce the extent of apparent nutritional deprivation, but the debate still rages on as to whether this is justified by the nutritional requirements for a healthy rural life. Even so, there is clear evidence that calorie intake has improved over time and the extent of severe food deprivation has fallen. FAO (2000) estimated that the share of China's population with insufficient calorie intake (based on a lower norm of 1920 kcal per day per capita) fell from 30 per cent in 1979–1981 to 17 per cent in 1990–1992 and 11 per cent in 1996–1998.

Stunting is an indicator of long-term under-nutrition in children. Here too, while the rates for rural China are high, they have declined over time (from 41.4 per cent in 1990 to 22 per cent in 1998). They are now significantly better than for India or countries in sub-Saharan Africa.

On the health front, morbidity indicators in China indicate a clear shift towards life-style diseases away from communicable diseases, which is usually a feature of development and increasing incomes. Chronic non-communicable diseases now account for an estimated 80 per cent of total deaths (Wang, *et al.* 2005), with the major causes of death being cardiovascular disease, cancer and chronic respiratory disease. Only the last is disproportionately associated with poverty, but in China, it is also strongly linked to smoking which is still widely prevalent. Indeed, the most common health problems in China today relate to tobacco use, blood pressure and obesity, which are not typical of poor populations.

However, health indicators vary widely between rural and urban locations and across provinces. In 2000, the average life expectancy of rural residents was 69.6 years, 8 per cent lower than the average for urban residents of 75.2 years. In 2005, child mortality rates in rural China (at 25.7 per 1,000 live births) were 1.4 times the urban rate of 10.7. Maternal mortality in rural areas in 2006 was nearly double that in urban China, at 45.5 per 100,000 live births compared to 24.8.

One important point to note is that conventional estimates of poverty do not take into account out-of-pocket expenses for health care, and that where these are high, this can lead to a “medical poverty trap”. This issue is important for China where the extent of public provision of health care and the degree of subsidy involved both declined in the 1990s, especially for rural Chinese. Van Doorslaer, *et al.* (2006) have identified the impact this has on estimates of poverty in eleven developing countries, including China and India. They conclude that out-of-pocket expenses for health care exacerbate both the prevalence and the depth of poverty. In China, they were found to increase the incidence of poverty in 2000 by nearly 20 per cent, causing an increase from 13.7 per cent (using the World Bank's head count ratio based



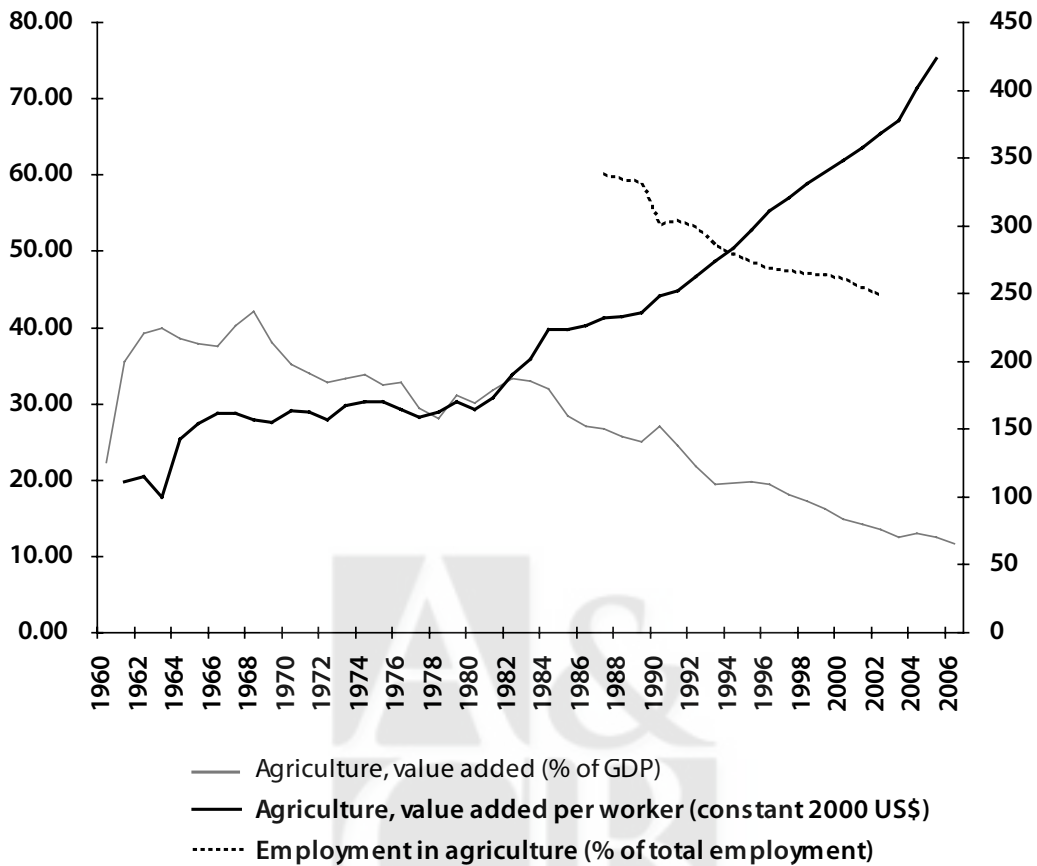
on \$1.08 PPP per day) to 16.2 per cent. In India, the corresponding numbers for 1999–2000 were 31.1 per cent and 34.8 per cent.

A more detailed study using official poverty lines for China (Gustafsson and Li 2004) based on household survey data for 1988 and 1995, not only found that education and health expenditures in rural China increased rapidly between 1988 and 1995, but also that they constituted a much higher share of expenditure in poor households. They argue that once these expenditures are taken into account, it is no longer possible to state that poverty decreased during this period of rapid economic growth. Clearly, therefore, greater public funding of health care and basic education expenses become important poverty reduction measures.

### *Poverty Reduction Strategies in China*

One of the most important tendencies with a direct bearing on poverty reduction is the overall pattern of growth and structural change. As noted in the first section, China's recent growth has been along the classic Kuznets-style trajectory, with an increase in the share of the manufacturing sector in both output and employment. A crucial feature of such a positive tendency is agrarian transformation. It is evident from Figure 5.3 that the share of agriculture in both output and employment has declined since the early 1980s. This is different from a number of other developing countries (including India) where the share of agriculture in employment remains high. So, the ability of the Chinese growth pattern to generate more productive and remunerative employment outside agriculture played an important role. In addition, per worker output in agriculture increased dramatically from the early 1980s, reflecting the institutional changes described earlier. What is significant is that it continued to increase at a rapid rate thereafter, such that it nearly doubled in the decade after 1995. This has clearly played a very important role in rural poverty reduction, dwarfing the effect of particular poverty alleviation schemes, but it is necessary to remember that it is the specific pattern of agricultural growth in China that mattered. The growth was broad-based and widely shared because of the egalitarian land distribution as well as the simultaneous creation of non-agricultural employment opportunities.

Figure 5.3:  
China: Agriculture in GDP and employment



Source: Groningen Total Economy Database, <http://www.conference-board.org/economics/database.cfm>

On the basis of an econometric study on the variables influencing rural poverty, Fan, Zhang and Zhang (2002) argued that increasing agricultural output remains the key to poverty reduction, and this is significantly positively influenced by public investment, in agricultural research as well as in rural infrastructure and education. They found that government expenditure on education had the largest impact on reducing both rural poverty and regional inequality, and a significant impact on boosting production. Increased rural non-farm employment accounted for a significant part of the reduction in both poverty and inequality, and the large positive impact of rural infrastructure spending was found to come mainly from improved non-farm employment opportunities. Interestingly, they found low poverty reduction impacts of both public irrigation spending and loans (micro-credit) provided as part of anti-poverty programmes.

Rozelle, Zhang and Yuang (2000) argued, on the basis of an econometric study, that poverty alleviation in China can be largely attributed to economic

growth; also, it is the *pattern* of growth, rather than its rate, that has been crucial. According to them, the effectiveness of poverty programmes has been limited by problems related to targeting (associated with errors of unfair exclusion and undeserved inclusion) and inappropriate project design along with inefficient fund allocation. They also found that of such programmes, those that are household-based, with funds reaching local agencies, have been more successful.

Huang and Yang (2004: 77) note that poverty reduction strategies need to focus on the country as a whole, rather than deal separately with rural and urban poverty through targeted schemes. According to them, “it is important to enhance government intervention in income distribution, and adjust and regulate income distribution policies. One of the most important reasons for the formation of the present poverty problems in China is the disorder of income distribution and existence of unfairness”.

An important factor may be the lag in ensuring redistributive fiscal policy. Until recently, the tax system was not based on the principles of a market economy and did not encompass the now widespread possibility of individual wealth accretion. Wages and salaries have been the only taxable incomes (Wu 2002) even though property-based incomes of different sorts and newer types of remuneration for highly paid professional workers have both become more quantitatively significant. According to Huang and Yang (2004), a large portion of individual income tax is collected from average workers and employees, while high-income individuals find all sorts of ways to avoid taxes. Rural residents were, until recently, taxed much more heavily than urban residents, even though the incidence of poverty is still acknowledged to be much higher in rural China. The scrapping of the agricultural tax in 2006 may not only have contributed to overall agricultural incomes, but also contributed to the reduction of rural poverty, although the impact is not yet clear from the data. Tax rates have been low overall and more dependent on indirect taxes. All this has reduced the potential for redistributive expenditures, including on social security that would directly have a bearing on poverty alleviation. The poor—in both rural and urban areas—are those who are largely outside the coverage of the social security system, which includes not only a minimum livelihood guarantee, but also livelihood protection for laid-off workers of state-owned enterprises, unemployment protection, subsistence allowances for urban residents, basic old age pension, unemployment insurance, medical insurance, working injury insurance and birth insurance for females.

The fiscal system operated in another way to impact upon the extent of inequality and poverty, by reducing incomes of communes in poorer parts of the country. Decentralization had the effect of reducing fiscal transfers especially to

provincial governments, municipalities and communes in the central and western parts of the country, and this in turn meant a cutback in their health and education provision and social security benefits. Also, there was inequality in the distribution of such fiscal transfer as did occur in the 1980s and early 1990s, reinforcing the inequality in growth that disproportionately favoured the eastern region. However, this seems to have been reversed from the mid-1990s, and especially after 2002. During the period 1994–2005, only 10 per cent of the central fiscal transfers went to eastern provinces, but 44 per cent went to central provinces and 46 per cent to western provinces. Therefore it is likely that in the more recent period, central fiscal transfers have helped to reduce both vertical and horizontal fiscal imbalance and thereby regional inequalities.

Obviously, increasing public expenditure on health and education services is likely to have significant effects on poverty reduction, as noted above. It is therefore heartening to note that since the early part of this decade, such expenditures have been increasing, both in terms of share of total government expenditure and share of GDP. As a result, the share of out-of-pocket expenses in total spending on health care fell from around 60 per cent in 2002 to just above 50 per cent in 2005 (Wang Shaoling 2006).

Overall, it could be argued that poverty reduction in China has been more strongly related to changes in economic structure and in inequality than to GDP growth *per se*. If so, China's ability to sustain the pace of poverty reduction will depend on its ability to keep in place recent policies aimed at reducing inequality as well as ensuring that structural change remains positive and dynamic. This is in keeping with lessons from the pre-reform experience as well. China was served well by a combination of egalitarian land distribution and experience with commune, collective and cooperative forms of organization, which ensured a degree of income equality and helped release and pool labour resources for undertaking non-agricultural activities jointly managed with State support. To the extent that economic reform undermines such egalitarianism and adversely affects the growth of the TVEs, it would set back poverty reduction as well.

## POVERTY REDUCTION IN INDIA

While India's recent economic growth experience has been less spectacular than China's, it has still been extremely impressive by the standards of most other developing countries in the same period and in comparison to its own past. Table 5.2 shows that real GDP growth rates increased to a higher level in the last two decades. Increases in per capita income were even more marked because of the fall in the rate of population growth.

Table 5.2:  
**Annual rates of growth of national income (per cent)**

Period (average of years)	Rate of growth of real GDP (over previ- ous period) per cent	Share of GDP			
		Investment rate	Primary	Secondary	Tertiary
1950–52		15.5	59.0	13.4	27.6
1960–62	3.9	19.4	53.1	17.3	29.6
1970–72	3.5	23.8	46.6	20.4	33.0
1980–82	3.5	22.0	41.3	21.8	36.9
1990–92	5.6	26.0	34.4	24	41.6
2000–02	5.6	26.2	26.1	24.7	49.2
2004–06	7.1	29.3	22.0	24.0	54.0
2006–08	9.3	35.9	17.8	26.4	55.8

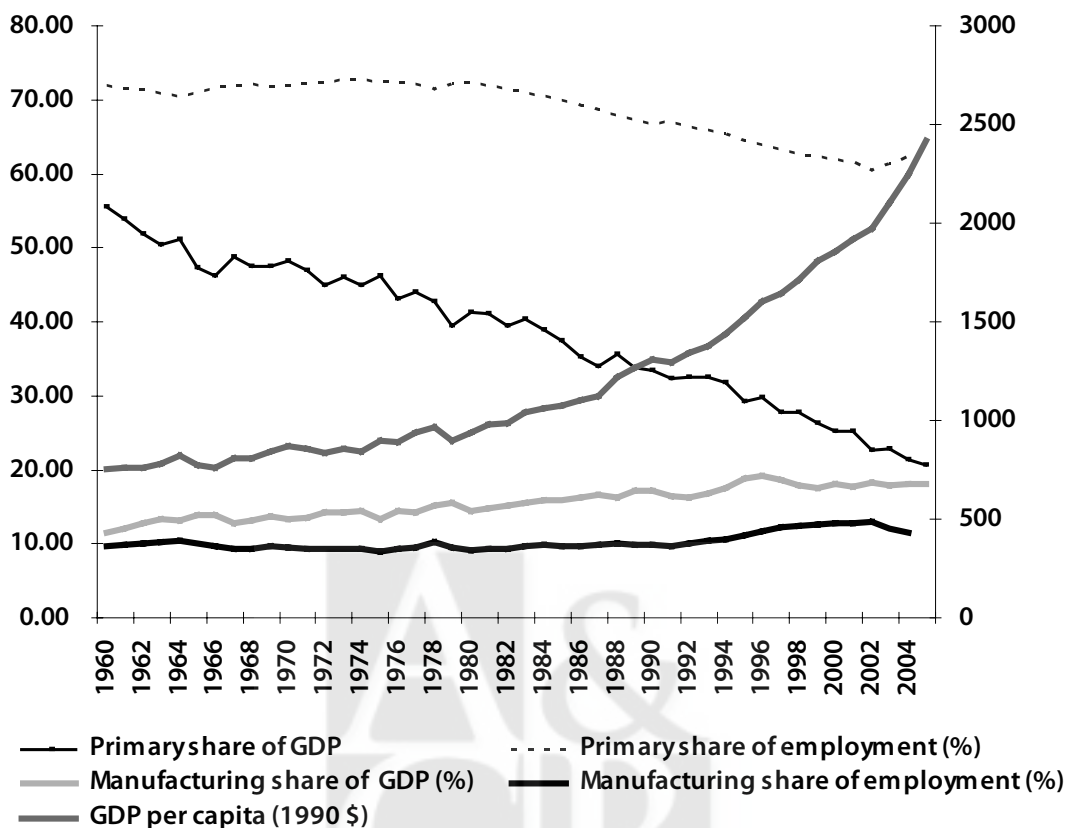
*Notes:*

1. Both GDP and NNP are measured in constant 1993–94 prices, except for 2005–2006 onwards, for which the data are in 1999–2000 prices.
2. Rates of growth are compound annual rates for the three-year averages.

*Source:* CSO, National Accounts Statistics, various issues

This has been associated with some amount of structural change, although perhaps not as much as might be expected. Investment rates have increased over time, which is only to be expected in a developing economy achieving higher rates of per capita income growth, and have moved up especially rapidly in the current decade, to around 36 per cent now. Meanwhile, the share of agriculture in GDP has fallen along predictable lines in the course of development, but there has been little increase in the share of the secondary sector, which has not changed at all since the early 1990s (Figure 5.4). Rather, the share of the tertiary sector has increased dramatically, to the point where it now accounts for around half of national income.

Figure 5.4:  
Structural change in India



Source: World Bank, World Development Indicators online.  
[www.worldbank.org/data/wdi2005/index.html](http://www.worldbank.org/data/wdi2005/index.html)

Such changes in output shares were not accompanied by commensurate changes in the distribution of the workforce. The proportion of all workers engaged in primary activities as the main occupation has remained stubbornly around 60 per cent, despite the collapse in agricultural employment generation in the most recent decade and the fall in agriculture's share of national income. The higher rates of investment of the last two decades have not generated more expansion of industry, but have instead been associated with an apparent explosion in services, a "catch-all" sector combining both high-productivity and low-productivity activities. These tendencies, and particularly employment patterns, have had major effects on the incidence of poverty.

### *Income Inequality and Poverty in India*

The evidence suggests that economic inequalities have increased in India in the post-reform period. Most studies have used various rounds of NSS consumption expenditure survey statistics to calculate per capita incomes and

Gini coefficients. As regards inequality, it is well known that the NSS surveys, with a relatively low lower bound for its highest expenditure range, do not capture upper income group consumption adequately. With regard to consumption estimates, there is a problem of lack of comparability of NSS statistics between the quinquennial large-sample consumption survey for 1999–2000 (55th Round) and the earlier ones.<sup>5</sup> According to Sen and Himanshu (2005), this lowered the measured rural poverty in India by almost 50 million and also affected inequality measures.

Revised estimates of rural inequality have been calculated by Deaton and Dreze (2002), Sundaram and Tendulkar (2003a, 2003b) and Sen and Himanshu (2005). General observation of these studies show that though unadjusted data show inequality was reduced between rounds 50 and 55, if one uses (comparable) adjusted data, rural inequality in fact went up in India between 1993–94 (50<sup>th</sup> Round) and 1999–2000 (55<sup>th</sup> Round). Striking evidence about increased inequality in India in the post-reform period comes from Sen and Himanshu (2005). Based on indices of real mean per capita expenditure (MPCE) on a uniform reference period (URP) basis by fractile groups, whereas the consumption level of the upper tail of the population, including the top 20 per cent of the rural population, has gone up remarkably during the 1990s, the bottom 80 per cent of the rural population has suffered during this period. This graph clearly shows that the income/consumption disparity among the rich and poor and among urban and rural India has increased during the 1990s.<sup>6</sup>

There has been both increased rural-urban inequality in per capita expenditure at an all India level and greater rural-urban inequalities within states between 1993–1994 and 1999–2000 (Deaton and Dreze 2002, CSO 2007). Urban per capita NDP in 1999–2000 was estimated to be around 3 times that in rural India. The ratio of urban to rural per capita consumption, based on National Sample Survey data, has been increasing continuously from 1.55 in 1987–1988 to 1.63 in 1993–1994 to 1.75 in 1999–2000 to 1.9 in 2004–2005. While this trend is similar to that in China, what is striking is that, unlike China, the rate of urbanization appears to have decelerated in the period of high growth, with cities and towns becoming less welcoming of rural migrants (Kundu 2007).

Regional income differences have intensified, with the Gini coefficient for per capita incomes across the states of India increasing. Sen and Himanshu (2005) also find that state-wise rural and urban Gini coefficients, adjusted for changes in estimates, increased for a majority of states between 1993–1994 and 1999–2000. For all-India, the rural Gini increased from 25.8 to 26.3 per cent, and the urban Gini increased from 31.9 to 34.8 per cent. This is generally accepted to be an underestimate because the data cover consumption

expenditure, rather than income, and because the survey is known to underestimate the tails of the distribution. The lowest decile of the population accounts for only 3.6 per cent of estimated aggregate consumption, while the top decile accounts for 31.1 per cent (NSSO 2006).

Rural-urban income differentials are large: urban per capita consumption is more than twice that in rural areas (NSS 2006) and per capita GDP gaps are even larger, with urban per capita income estimated to be around three times rural per capita income in 2004 (Sen and Himanshu 2005). Regional differences are also significant and have increased recently: the ratio of the per capita State Domestic Product of the richest major state (Punjab) to that of the poorest major state (Bihar) increased from 2.2 in 1980 to 4.8 in 2004 (Pal and Ghosh 2007).

Official estimates of the extent of poverty, i.e. the head count ratio below the official poverty line, have been the subject of much debate. One commonly cited recent problem relates to the comparability of consumption expenditure estimates over time, especially given the problems with the 1999–2000 survey. However, concerns have also been expressed with the determination of the poverty line itself (Utsa Patnaik 2005, 2008). The current poverty line is based on the line first determined in the 1970s, based on the consumption expenditure level at which a household was procuring sufficient food to meet the average calorie requirement of 2400 kcal per day in rural areas and 2100 kcal per day in urban areas. This line, determined in 1973, has been extended for subsequent years based on the consumer price indices for agricultural labourers in rural areas and for industrial workers in urban areas.

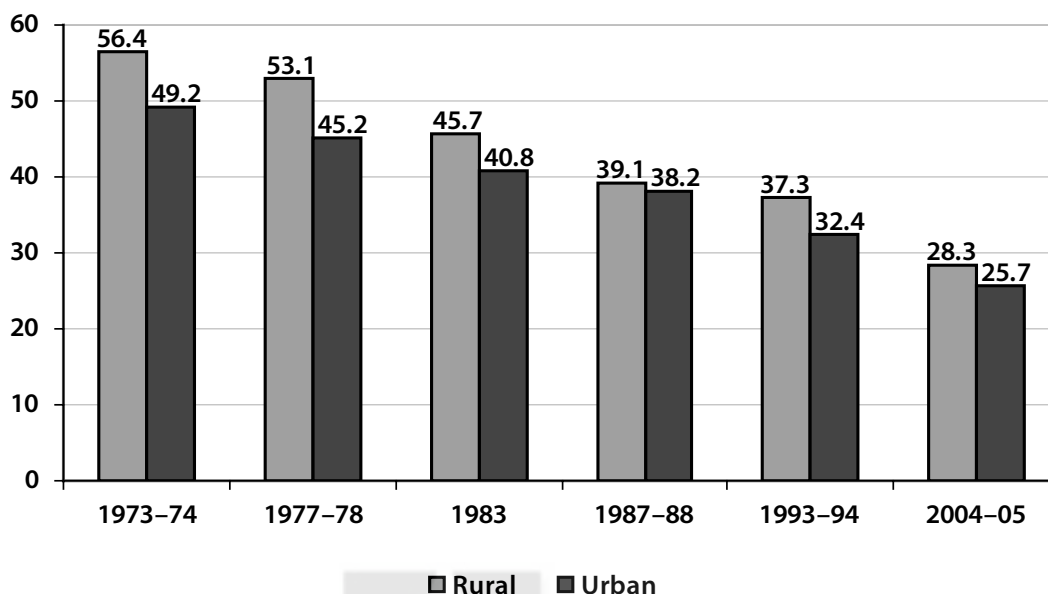
Several criticisms can be directed against such a method: that it does not take into account the changing consumption basket of explicit and implicit necessities, including health care costs and energy costs; that it no longer bears any relation to actual calorie intake, which was the basis for deriving the original line; that it does not even always ensure that households at or above the poverty line can purchase sufficient food to meet the calorie requirements at prevailing prices.

Nevertheless, even these official data provide some cause for introspection on the slower rate of poverty reduction in the recent period of fast economic growth. Figure 5.5 provides evidence on the head count poverty ratios in rural and urban India. It is clear that poverty, as officially defined has been declining continuously since the early 1970s. However, what is remarkable is that in the recent period, which is when growth rates picked up, the rate of poverty reduction decelerated, especially in rural India.



Figure 5.5:

India: Official poverty estimates (% of population below poverty line)



Source: Planning Commission, Government of India

This is confirmed by Table 5.3, which shows the actual rates of poverty reduction according to official estimates over the two periods that can be broadly described as pre- and post-economic liberalization. It is evident that rural poverty reduction in particular was much more rapid in the earlier period, characterized by relatively slower growth and continued state intervention in the productive sectors of the economy.

Table 5.3:

Rates of poverty reduction

	Rural India	Urban India
<b>Annual poverty reduction in percentage points</b>		
1973-74 to 1987-88	-1.24	-0.79
1987-88 to 2004-05	-0.64	-0.74
<b>Annual poverty reduction normalized to initial year, per cent</b>		
1973-74 to 1987-88	-2.19	-1.60
1987-88 to 2004-05	-1.62	-1.92

Source: Planning Commission, Government of India

Other estimates of the incidence of poverty also find that it has been remarkably persistent, especially in rural India, and also much higher than the official Indian estimates. The most recent World Bank estimates (Chen

and Ravallion 2008, using a cut-off of \$1.25 per day at revised 2005 PPP\$) estimated the number of absolutely poor people in India in 2005 to be 456 million, significantly more than the Indian government's own estimate of 301 million in 2004–2005. According to these estimates, the aggregate head count poverty ratio in India declined from 59.8 per cent in 1981 to 51.3 per cent in 1990 and 41.6 per cent in 2005. So, according to the World Bank, the rate of poverty reduction slowed from 0.94 percentage points per annum during 1981–1990 to only 0.65 percentage points per annum during 1990–2005. On these trends, India would not meet the MDG of halving poverty by 2015.

The Asian Development Bank (2008) estimate of the number of poor in India in 2005 is well over double the official Indian estimate, at between 622 to 740 million. The higher estimate is because the ADB used a higher Asian poverty line of \$1.35 PPP per day per person rather than the \$1.25 per day per person used by the World Bank. It also made an attempt to improve upon the World Bank by using price data for goods and services purchased by the poor rather than the usual ICP comparison relating to an overall consumption bundle (Himanshu 2008). This gives India the second highest poverty ratio (at 54.8 per cent) among all the Asian countries considered by the ADB, next only to Nepal (55.8 per cent) and higher than Bangladesh (42.9 per cent), Cambodia (36.9 per cent), Philippines (29.5 per cent), Pakistan (24.9 per cent) and Indonesia (24.1 per cent). It should be noted, of course, that the determination of both the poverty line and the PPP measures employed by both the World Bank and the ADB have been criticized (Reddy and Pogge 2002, Reddy 2008) on the grounds that they do not anchor the line on any defined set of requirements for human life, and that the PPP conversion factors are themselves problematic, based on inadequate data and an unchanging perception of consumption needs over time. Nevertheless, the different sets of data all point to the same conclusion: that Indian poverty reduction has been relatively slow, and certainly much below what would be expected given the rapidity of income growth in the past fifteen years.

### *Human Poverty in India*

Human poverty measures suggest even worse outcomes than for income poverty in India. India has never been a good performer in human development terms, despite the much better indicators in some states, particularly Kerala. Overall, both health and education indicators have lagged well below those in other countries at similar levels of development and with similar per capita incomes. But food poverty has been of particular concern. Recent studies

have shown alarming levels of hunger, especially in certain states of India. Studies by IFPRI and ISHI quoted in Banerjee (2008) suggest that most states in India rank somewhere among the poor sub-Saharan countries: Punjab, Kerala, Andhra Pradesh and Assam have a “serious” level of hunger; Madhya Pradesh fares worst in the “extremely alarming” cohort of hunger. All the other states record an “alarming” level of hunger, which is also the general ranking for the whole country. More appallingly, the situation appears to have worsened in the recent period of rapid economic growth. National Sample Surveys point to declining per capita calorie consumption, not only among the entire population, but also among the bottom quartiles, for which consumption was already very inadequate by international standards, as shown in Table 5.4.

Table 5.4:  
Calorie insufficiency in India (per cent of population)

	Rural		Urban	
	1999–2000	2004–2005	1999–2000	2004–2005
2400 Kcal per day	74.5	87		
2200 Kcal per day	58.5	69.5		
2100 Kcal per day			20.0	25.0

Source: Utsa Patnaik (2007) based on NSSO data

Other indicators of both nutrition and health are also extreme. The latest National Family Health Survey for 2005–2006 shows that the proportion of underweight children below the age of five years was 45.6 per cent in rural India and 32.7 per cent in urban India, indicating hardly any change from the previous survey undertaken eight years previously. More than one-third of the rural population was also underweight. Anaemia—often a good indicator of nutritional deprivation—was also widespread: 79.2 per cent of children aged 12–23 months and 56.2 per cent of ever-married women between 15 and 59 years were found to be anaemic.

Health has also become a greater source of inequality and also poverty. Health care services in India are increasingly characterized by extreme duality, with the rich opting for deluxe institutions with “world class” infrastructure. The poor are either forced to avail of very overcrowded and underfunded public facilities, or to access medical shops where they are routinely exploited and often provided with inadequate care. The inadequate contribution of the government has meant that out-of-pocket expenses for health in India account for 85 per cent of total health expenditure, one of the highest ratios in the world. Van Doorslaer, *et al.* (2006), using the NSS data for

1999–2000, found that accounting for health costs increased the incidence of poverty by 3.7 percentage points, or 12 per cent.

The role of public intervention, in terms of ensuring clean, safe water and immunization, is obvious for communicable diseases which are passed either directly among humans or indirectly through the physical environment. Nevertheless, both central and state governments in India have become increasingly remiss about ensuring such minimal expenditure and taking basic precautions. Health expenditure of central and state governments taken together declined from more than 1 per cent of GDP in the mid-1980s to only 0.9 per cent in the mid-2000s. Central government expenditures on health alone have been completely flat at only 0.1 per cent of GDP, which is one of the lowest ratios in the developing world. A number of state governments have actually shown declines—sometimes significant—in per capita health expenditures, especially for public health such as immunization. Rates of immunization of children aged 12–23 months also remain very low: in 2005–2006 only 58 per cent of urban children and 39 per cent of rural children had received all the necessary vaccinations, which was almost the same as in 1997–1998. The rates had even come down in some states, including fast growing states like Gujarat. In three of the richest states of India—Maharashtra, Punjab and Gujarat—per capita public spending on health declined in constant price terms after 2000. And the NFHS results indicate that in these three states, immunization rates of children in the 12–36 months age group actually fell in 2004–2005 compared to 1998–1999. In some cases the decline is dramatic—from 78 to only 59 per cent in Maharashtra, for example.

In addition to other sources of inequality, social groups—particularly caste and community—remain important sources of economic differentiation, and within households, gender differences remain high and have even grown (in terms of rising gender wage gaps). Social divisions extend beyond religious and ethnic groups to caste divisions, which in India, are not confined to Hindus, but are also implicitly recognized and practised in other religious communities. There were hopes and expectations that such divisions would decrease or disappear in the course of economic development. This has not really happened to the anticipated extent, even in the more advanced urban areas. Instead, caste awareness is increasingly reflected in identity politics that has led the political process to emphasize affirmative action such as reservation. Scheduled Castes (16.2 per cent of the population) and Scheduled Tribes (8.2 per cent) were explicitly recognized in the Constitution as being particularly deprived, and were given reservations in official employment and higher education (15 per cent for SCs and 7.5 per cent for STs). Nevertheless, the actual shares of both remain low, well below their mandated levels, largely because reservations

have not been effectively enforced, and affirmative action has not taken any other forms such as asset redistribution or ensuring good quality school education that would more than proportionately benefit such groups. More recently, Other Backward Castes (OBCs) have been awarded reservations in both government employment and higher education, although this policy remains hotly contested. There are proposals to extend such reservation to the private sector, although this has not yet been legislated. In addition, it has been noted that Muslims are also significantly deprived educationally and marginalized occupationally, and there may be attempts to rectify this through official policy in the future—indeed, some states already have some measures in place.

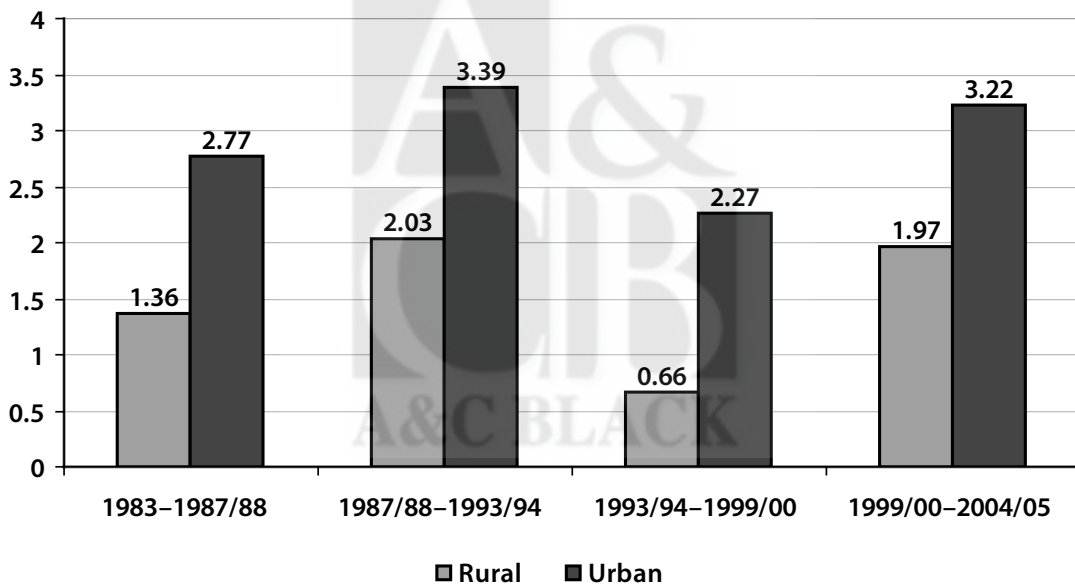
### *Factors Behind the Poverty Trends in India*

What explains this persistence of poverty and the apparently paradoxical divergence between growth rates and poverty reduction? Clearly, increasing inequality is an important factor, since it has meant that the benefits of the growth have been concentrated and have not “trickled down” sufficiently to ensure improved consumption among the lower income groups. But the pattern described here also emphasises the crucial importance of the nature of the growth. Thus, the period 1973–1974 to 1987–1988 witnessed faster reduction in rural poverty because the pattern of growth especially in the 1980s, involved a shift of public expenditure at the margin to rural areas, and this generated multiplier effects and more employment that benefited the rural poor to some extent (Sen and Ghosh 1994).

Unlike in China, the terms of trade play a more complex role in changing levels of poverty: the presence of a large mass of landless labourers as well as marginal peasants who are often net purchasers of food, means that rising agricultural (especially food) prices actually increase poverty even in rural India. In fact, several earlier studies relating to the 1960s have had a direct link between food prices and poverty incidence. The relevant variable is not the nominal food price level, but the relative price of food and the rate of increase of nominal food prices. A faster rate of increase of agricultural prices can have two contradictory effects on poverty. First, to the extent that agricultural growth is stimulated by a shift in terms of trade in favour of agriculture, and assuming that inequality does not increase, the rise in agricultural prices would contribute to a reduction in rural poverty to some extent. Second, since a large part of the rural population consists of agricultural labourers, small farmers and non-farm workers, who are all net purchasers of food, a sharp increase in the price of food would squeeze real incomes and worsen poverty.

In recent years, the relationship between food prices and poverty has become more complex due to the effect of other factors, especially employment and wages. In general, productive employment generation is a crucial link between growth and poverty (although the link is not automatic, as the remuneration of work is critical). The recent economic growth process in India has exhibited a problem which is increasingly common throughout the developing world: the apparent inability of even high rates of output growth to generate sufficient opportunities for “decent work” to meet the needs of the growing labour force. As Figure 5.6 indicates, the period of rapid GDP growth has not been accompanied by significantly higher rates of net employment generation, with the employment growth in the most recent period still slower than the rates of expansion achieved in the period 1987–1988 to 1993–1994.

Figure 5.6:

**Annual rates of employment growth for usual status workers (percentages)**

Sources:

1. NSSO, various rounds of Survey of Employment and Unemployment in India, for employment rates
2. Census of India for population figures

In addition, employment growth has been accompanied by significant increases in the rate of open unemployment, as aggregate and age-specific labour force participation rates have increased, especially for women. Further, more detailed data reveal that the quality of employment has deteriorated significantly, with less days worked per year and more reliance on precarious low-remuneration self-employment. There has been a significant decline in the proportion of all forms of wage employment. While regular employment

had been declining as a share of total usual status employment for some time now (except for urban women workers), the share of wage employment had continued to grow because employment on casual contracts had been on the increase. But the latest survey round suggests that even casual employment has fallen in proportion to total employment.

So, the official data also suggest that despite rapid economic growth, there has been increasing difficulty among the working population in finding paid jobs, whether in the form of regular or casual contracts. Agricultural employment showed the sharpest deceleration of all, with absolute declines in the number of people employed in agriculture over the 1990s. Part of this was due to technological and cropping pattern changes that reduced labour demand in agriculture. In addition, the growing land alienation by the peasantry (as cultivation became less viable given the squeeze on the peasantry because of rising input costs and falling or stagnant crop prices) also had an impact, since peasants using family labour tend to use labour more intensively than farmers using hired labour.

For urban India, the growth deceleration and even decline in organized sector employment were some of the more disturbing features of the period after 1990, especially given that industrial output increased manifold and the service sector (in which much of the organized employment was based) was the most dynamic element in national income growth.<sup>7</sup> This was due to the decline in public sector employment, which was not compensated for by the increase in private organized sector employment. Further, several “economic reform” measures—such as trade liberalization, the reduction of credit allocation to the priority sector and the removal of various forms of support—worked against the interests of most small producers, who accounted not only for the most labour-intensive forms of urban production, but also for the dominant part of urban manufacturing employment.

The fallout of all this has been a very significant increase in self-employment among all categories of workers in India. The increase has been sharpest among rural women, where self-employment now accounts for nearly two-thirds of all jobs. But it is also remarkable for urban workers, both men and women, among whom the self-employed constitute 45 and 48 per cent of all usual status workers respectively. All told, therefore, around half of the work force in India currently does not work for a direct employer. This is true not only in agriculture, but increasingly in a wide range of non-agricultural activities. Further, more than half of men and nearly two-thirds of women among such self-employed workers reported monthly remuneration that is very low, indeed below the official minimum wages in most states.

The notion of the “working poor” therefore has to go beyond those in direct wage employment, to those engaged in often precarious and generally low-paying self-employment. This, in turn, requires a significant rethinking of the way analysts and policy makers deal with the notion of “workers”. Several new policy problems emerge: the difficulty of ensuring decent conditions of work when the absence of a direct employer means that self-exploitation by workers in a competitive market is the greater danger; the difficulty of assessing and then ensuring “living wages” when wages are not received by such workers, who instead depend on uncertain returns from various activities that are typically petty in nature; the need to develop new forms of policy intervention to improve work conditions and strategies of worker mobilization in this context. Self-employment thus also brings home the urgent need to provide basic social security that covers not only workers in the unorganized sector, but also those who typically work for themselves.

The growth of rural non-farm activities and employment has contributed to the reduction in rural poverty in India as in other countries, especially China. Further, the subsequent deceleration of poverty reduction, especially in rural India in the later period, can be related to the stagnation of rural employment opportunities in the 1990s and thereafter. Similarly, in urban India, changes in the nature of employment and inadequate generation of productive income opportunities have been major factors in the persistence of poverty. Thus, in India, rapid economic growth has not contributed to substantial poverty reduction, because of the negative effects of macroeconomic policies and processes on food prices and employment generation. Hence, poverty reduction has depended on the extent to which the following features have been achieved: a relatively egalitarian growth path; increases in agricultural productivity that help raise wages and keep food prices under control; expansion of non-agricultural employment, including in rural areas; and direct public action in the form of poverty eradication programmes aimed at generating productive employment for the poor. The process of fairly continuous poverty reduction from the late 1970s to the early 1990s hinged on a combination of a certain growth pattern with expansion of rural non-agricultural employment led by public expenditure increases. The subsequent slowdown in the pace of poverty reduction has been associated with macro policies that have adversely affected employment generation, especially rural employment generation, possibly worsened inequality in consumption and contributed to an increase in the relative price of food.



## CONCLUSION

These differing stories of poverty reduction in the two countries that were among the high-growth economies of the past three decades provide some important lessons. The first is that economic growth *per se* need not deliver either income poverty reduction or improvements in the conditions of human poverty. Instead, what matters crucially is the nature of the growth: the extent to which the growth is associated with growing inequalities that do not allow the benefits of growth to reach the poor; the extent to which the structural change involved in the growth process generates sufficient opportunities for productive non-agricultural employment; the extent to which markets and states function in ways that ensure the provision of basic needs and universal access to essential social services. All this also means that government mediation of the process of global economic integration matters in affecting the processes that will ultimately determine the extent to which economic growth delivers better conditions for the poor.

It should be clear that for China, the egalitarianism that the Chinese revolution ensured and the control the state could continue to exercise because of the persistence of substantial state ownership of and investment in capital assets as well as the continuance of the earlier financial structure and system, meant that the process of global economic integration was carried out under fundamentally different premises from that which occurred in India. To a significant extent, some basic development issues, including ensuring adequate food supplies and universal primary education, were already dealt with. The domestic market for consumption goods was also significantly larger than proved to be the case in India. The control retained by the Chinese state over financial institutions and the activities of state-owned enterprises (SOEs) allowed it to sustain high levels of investment and to deal with volatility, to prevent undesired levels of inflation from persisting beyond relatively short periods. In the event, the state ensured that cyclical fluctuations occurred around a high overall trend rate of income growth.

The early phase of economic reforms in China, which essentially involved increasing remuneration to farmers, operated substantially to reduce poverty and deprivation. Subsequently, the heavy emphasis on infrastructure development, combined with some “controlled” trade and investment liberalization, created much greater possibilities for employment generating, export-oriented industrialization, which became the next engine of growth. As this occurred in a context of still heavily regulated and monitored imports, it ensured that export employment provided a net addition to aggregate manufacturing, rather than having to balance for losses in employment in other

domestic sectors, since these did not really have to face import competition on par with other countries that underwent trade liberalization in that period. When import liberalization accelerated, some devaluation of the yuan in 1994 limited import competition. Thereafter, entry into the WTO required more sweeping import liberalization, but to some extent, that impact was counter-balanced by access to other markets that enabled the continuous expansion of exports with a cheap currency policy.

While delivering growth, the transition to a market driven system in China proved to be disequalizing beyond a point, not only in income terms, but also with reference to basic services. But recent measures by the Chinese state aimed at countering such tendencies and the migration-mediated process of trickle-down have helped to check these disequalizing outcomes. However, in as much as the current pattern of economic expansion is predicated on high rates of saving and investment as well as loosening the earlier credit and cash planning system, the dangers of volatile growth and inadequate reductions in unemployment and poverty persist. These will require appropriate macroeconomic corrections as well as supportive policies, especially in the new international context in which external markets are likely to play a dampening rather than a dynamic role. Since new growth stimuli will have to be sought in the new situation, and these are most likely to come from within the domestic market, this may be the moment to embark on a wage-led economic path that will simultaneously deliver growth and reduce poverty.

In comparison, India, with its market driven and demand constrained system, has not only failed to deliver the same growth success, but has also been far less successful with poverty reduction. Clearly, macroeconomic flexibility in a market-driven environment is not the best recipe either for growth and stability or for poverty reduction. India's growth experience, while higher than for many other developing countries, was still less than the rapid growth experienced by China and other East and Southeast Asian economies. And more fundamentally, it could not deliver the desired structural change in terms of the composition of output and employment that would have ensured substantial poverty reduction.

These inadequacies of the recent growth process in India were related to the reduced public expenditure by the Indian state in the period of reform, most significantly the substantial reduction in central capital expenditure (mainly on infrastructure) as a share of GDP, but also public spending directed towards rural areas generally. In addition, central government policies created resource problems for the state governments in various ways, forcing them to cut back on crucial developmental expenditure. This meant that first, rates of aggregate income growth were well below those which could have

been achieved; and second, that employment growth was well below the rate of GDP growth. These problems were compounded by the effects that trade liberalization had on small scale production in some manufacturing sectors. Agrarian distress and inadequate employment generation have thus emerged as the currently most significant macroeconomic problems.

Of course, it is also true that the Indian experience allowed for greater financial and macroeconomic stability than experienced by many other “emerging markets” over this period. However, this was primarily because, until relatively recently, liberalization of the capital account was limited, and India was not an attractive destination for finance capital until 2004. In the past four years, changes occurred on both these fronts, and the Indian economy experienced a surge in capital inflows that exerted upward pressure on the exchange rate and reduced macroeconomic flexibility. It is in this context of much greater global economic integration than even a decade earlier (with the value of all current account transactions amounting to more than 110 per cent of GDP in 2007–2008) that India is now experiencing the unfortunate collateral damage of the global financial crisis and economic slowdown, which has already affected output and employment quite substantially. Since the development project in India is still far from complete, and indeed is much less advanced than in China, it is crucial for the Indian government to use this opportunity to use expansionary fiscal policy and redirect both public and private investments towards the creation of infrastructure and the provision of basic needs. It is only with such a determined effort that any future growth will actually deliver poverty reduction.

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## NOTES

- 1 Almost all the studies which have found that global inequalities have declined in the period of globalization (Dollar and Kraay 2002, Surjit Bhalla 2003, Sala-i-Martin 2003, among others) rely very substantially on increased per capita GDP in China and India—which together account for around a third of the world's population—to arrive at their conclusion. Conversely, those who have been more sceptical of the impact of global economic integration on inequality have tended to look at patterns of inequality within these countries (Cornia 2003, Milanovic 2004, Reddy 2003, etc.) to find increased economic differentiation (including increased rural-urban inequalities) and, often, greater vulnerability of the poor in these countries (obscured by per capita GDP figures), which change conclusions with respect to global inequalities.
- 2 *China Statistical Yearbook*, various years.
- 3 This role should not be exaggerated: Germany is still the world's largest manufacturing exporter by a large margin.
- 4 By virtue of their *hukou*.
- 5 As Sen (2000) points out, the reference periods in the Consumer Expenditure Survey of the 55th Round of NSS survey were changed from the uniform 30 day recall used till then to both 7 and 30 day questions for items of food and intoxicants and only 365 day questions for items of clothing, footwear, education, institutional medical expenses and durable goods.
- 6 These findings are based on NSS “thin sample” surveys, conducted annually since 1986. These surveys are not as comprehensive as the NSS comprehensive rounds or the “thick sample” surveys, but provide sufficiently good estimates at the national level. Also, these thin sample results are comparable across successive surveys as they use a common form of questionnaire.
- 7 The only positive feature in employment patterns was the increased opportunities for educated groups, largely related to the expansion of IT-enabled services in metropolitan and other urban areas. However, while this feature, along with software development, received much international attention, it still remains too insignificant in the aggregate economy to make much of a dent in overall employment.

## Chapter 6

# The Bottom of the Pyramid Strategy for Reducing Poverty: A Failed Promise

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ANEEL KARNANI

A libertarian movement that emphasizes free markets to reduce poverty has grown strong in recent years. The think tank World Resources Institute advocates “development through enterprise” and emphasizes business models driven by a profit motive that engage the poor as producers and consumers. The Private Sector Development network, part of the World Bank, focuses on private sector led growth in developing countries. CK Prahalad (2005), a prolific exponent of this perspective, argues that selling to the poor people at the “bottom of the pyramid” (BOP) can simultaneously be profitable while helping eradicate poverty. The BOP proposition has caught the attention of senior executives and business academics. Many multinational companies (such as Unilever and SC Johnson) have undertaken BOP initiatives while some of the world’s top CEOs have discussed this topic at recent sessions of the World Economic Forum. Several business schools (such as the University of Michigan and the University of North Carolina) have set up BOP centres.

This libertarian approach to reducing poverty necessarily assumes that the poor are fully capable and willing participants in the free market economy. Prahalad (2005) explicitly urges us, in the very first paragraph of his book, to recognize the poor as “resilient and creative entrepreneurs and value-conscious consumers”. However, the rest of the book does not provide *any* empirical support for this assumption about the behaviour of the poor as consumers and as entrepreneurs. Having designated 2005 as the International Year of Microcredit, the United Nations declares on its website, “currently, microentrepreneurs use loans as small as \$100 to grow thriving business and, in turn, provide [for] their families, leading to strong and flourishing local economies”. This is hype and the United Nations provides no empirical evidence to support its bold assertion.

I will argue that the view of the poor as “resilient and creative entrepreneurs and value-conscious consumers” is empirically false. This romanticized view



of the poor does not help them, and actually harms the poor. First, it results in too little emphasis on legal, regulatory, and social mechanisms to protect the poor who are vulnerable consumers. Second, it results in over-emphasis on micro-credit and under-emphasis on fostering modern enterprises that would provide employment opportunities for the poor. More importantly, the BOP proposition grossly under-emphasizes the critical role and responsibility of the state for poverty reduction.

This is not to advocate a return to statist policies that have stifled economic growth. Contemporary economic history suggests that the market system is the best way to achieve overall growth and development. But that does not mean that there is no role for the state. Rajan and Zingales (2003: 293) persuasively argue that “markets cannot flourish without the very visible hand of the governments”. There is a need to impose some limits on markets to prevent exploitation of the poor (Karnani, 2007b). Another vital role of the state is to provide basic services such as infrastructure, public health and education. Both these responsibilities of the state are even more critical in the context of poverty reduction.

#### THE POOR AS VALUE-CONSCIOUS CONSUMERS

The BOP proposition views the poor primarily as potential consumers i.e. as untapped purchasing power. Providing increased consumption choices to the poor will increase their welfare, assuming rational consumers. It is almost an “item of faith” among development economists that the poor act rationally (*The Economist*, 2007). Some civil society organizations have argued that targeting the poor as a market might cause them to wastefully spend part of their already meagre income on low priority products and services (for example, Clay, 2005: Chapter 5). Hammond and Prahalad (2004) dismiss such arguments as patronizing and arrogant; how can anybody else decide what is best for the poor? The BOP proposition argues that the poor have the right to determine how they spend their limited income and are, in fact, value-conscious consumers; the poor themselves are the best judge of how to maximize their utility.

Only the expenditure patterns of the poor, and not their utility preferences, can be directly observed. The BOP proposition assumes—on ideological grounds, and without empirical evidence—that the poor must be maximizing their utility preferences, and that these preferences are congruent with the true self-interest of the poor. This is free market ideology taken to a dangerous extreme, and harms the poor. Even a stalwart proponent of neo-liberal policies

like *The Economist* concludes that the poor do make choices, and the empirical evidence suggests that “they are not always the best ones” (*The Economist*, 2007). I will argue below that the assumption that the poor are value-conscious consumers is empirically false; additionally, it is morally problematic.

The poor, in fact, are vulnerable due to lack of education (often they are illiterate), lack of information, and other economic, cultural and social deprivations. A person’s utility preferences are malleable and shaped by his or her background and experience, especially if he or she is disadvantaged (Sen, 2000). It is not appropriate to assume that the poor’s expressed preferences are truly in their self-interest. We need to look beyond their expressed preferences and focus on people’s capabilities to choose the lives they have reason to value. Amartya Sen (2000: 63), the Nobel Prize winning economist, eloquently states:

*The deprived people tend to come to terms with their deprivation because of the sheer necessity of survival, and they may, as a result, lack the courage to demand any radical change, and may even adjust their desires and expectations to what they unambitiously see as feasible. The mental metric of pleasure or desire is just too malleable to be a firm guide to deprivation and disadvantage. ... Social and economic factors such as basic education, elementary health care, and secure employment are important not only in their own right, but also for the role they can play in giving people opportunity to approach the world with courage and freedom.*

## EMPIRICAL EVIDENCE

Unfortunately, there are few micro-level studies on the purchasing behaviour of the poor. In an excellent survey of research on the consumption choices the poor make, Banerjee and Duflo (2007) show that the poor spend a “surprisingly large” fraction of their total income on alcohol, tobacco and entertainment (whether televisions, weddings or festivals). The poor enjoy such products as much as affluent people do, and maybe even more so, given their rather bleak lives of the poor. It is easy to rationalize any particular consumption choice of the poor. But, it is problematic that the poor do not spend enough on their own nutrition, health and education.

One survey of the poor in Udaipur in India found that 55 per cent of the adults were anaemic and that 65 per cent of adult men and 40 per cent of adult women were underweight (Banerjee, Deaton and Duflo, 2004). The typical

poor household in Udaipur could spend up to 30 per cent more on food than it actually does, just based on what it spends on alcohol, tobacco and festivals. Meenakshi and Vishwanathan (2003) find that the poor are buying less and less calories over time. Partly as a result of this general weakness, the poor are frequently sick. Banerjee and Duflo (2007) speculate that one cause of this surprising under-spending on nutrition is the “growing availability of consumption goods”.

The poor lack self-control and yield to temptation. One cause may be that the poor typically do not have bank accounts, and keeping cash at home makes it harder to exercise self-control. The poor seem to be aware of their vulnerability to temptation. In a survey in Hyderabad, India, the poor were asked to name whether they would like to cut particular expenses, and 28 per cent of the respondents named at least one item (Banerjee, Duflo and Glennerster, 2006). The top consumption items that households would like to cut are alcohol and tobacco, mentioned by 44 per cent of the households that wanted to cut consumption. Then came sugar, tea and snacks (9 per cent), festivals (7 per cent) and entertainment (7 per cent).

The evidence suggests that the poor lack self-control, yield to temptation and spend to keep up with their neighbours (Banerjee and Duflo, 2007). In this, they are little different from people with more money, but the consequences of bad choices are clearly more severe for the poor. Efrogmson and Ahmed (2001) tell a moving, but not uncommon, story of Hasan, a rickshaw puller, who spent \$0.20 per day on tobacco. When asked if his three children ever eat eggs, he exclaimed, “Eggs? Where will the money come from to buy them?” If Hasan did not buy tobacco, each of his children could eat an egg a day, or other nutritious foods, and be healthier as a result. For the more affluent, the consequences of smoking are not as bleak as children’s malnutrition.

There is much evidence (for example, Luttmer, 2005; Diener, Suh, Lucas and Smith, 1999) from economics and psychology showing that people derive satisfaction not just from their own consumption, but also from faring better than their peers. Fafchamps and Shilpi (2008) show that this is equally true for the poor. Keeping up with the neighbours seems to be a pervasive trait cutting across income brackets. Poor people in Nepal were asked to assess whether the levels of their income as well as their “consumption” of housing, food, clothing, health care, and schooling were adequate. The answers to these questions were strongly negatively related to the (average) consumption pattern of other people living in the same village.

Spending on festivals accounts for a surprisingly large part of the budget for many extremely poor households living on less than \$1 per day per person. In Udaipur, more than 99 per cent of the extremely poor households spent

money on a wedding, a funeral, or a religious festival (Banerjee, Deaton and Duflo, 2004). The median household spent 10 per cent of its annual budget on festivals. In South Africa, 90 per cent of extremely poor households spent money on festivals. In Pakistan, Indonesia, and Cote d'Ivoire, more than 50 per cent did likewise (Banerjee and Duflo, 2007). Spending on festivals is a form of entertainment, especially in the absence of movies and television, and provides rare respite from the bleakness of life. The need to spend more on entertainment appears to be strongly felt. One reason this may be so is that the poor want to “keep up with their neighbours”.

The empirical evidence does not support the romanticized view of the poor as “value-conscious consumers”. The problem is that the poor often make choices that are not in their own self-interest. The rich also often make choices not in their own self-interest, but the consequences are not as severe in their case. Selling to the poor can, in fact, reduce their welfare. Therefore, there is a need to impose some limits on free markets to prevent exploitation of the poor (Karnani, 2007b). Markets work best when appropriately regulated to protect the vulnerable. To examine one example in depth, I study below the consumption choices of the poor with respect to alcohol.

#### POVERTY AND ALCOHOL

Alcohol consumption is a financial drain for the poor. The reported share of household income spent on alcohol and tobacco by the poor is high in all countries, ranging from 6 per cent in Indonesia to 1 per cent in Nicaragua (Banerjee and Duflo, 2007). The poor in India spend about 3 per cent of their household income on alcohol and tobacco (Gangopadhyay and Wadhwa, 2004). These numbers understate the true consumption level since it is usually only the man in the household who engages in this consumption. In their in-depth field study, Baklien and Samarasinghe (2004) found that “money spent on alcohol by poor families and communities is underestimated to a remarkable degree. ... A large part of alcohol expenditure is unseen. ... Over 10 per cent of male respondents report spending as much as (or more than!) their regular income on alcohol”. Also, poorer people spend greater fractions of their incomes on alcohol than the less poor.

Aside from the direct financial cost, alcohol abuse imposes other economic and social costs affecting work performance, occupational health and industrial accidents. “Domestic violence and gender based violence was almost taken for granted in nearly all settings as an automatic consequence of alcohol use. Deprivation of the needs of children, due to the father’s heavy alcohol use, was regarded simply as a misfortune of the children concerned” (Baklien

and Samarasinghe, 2004). There is much evidence showing that alcohol abuse exacerbates poverty (for example, Assunta, 2001).

*The Economist* (2006a) cites SABMiller, which has succeeded in several African countries with Eagle, a cheaper beer made from locally grown sorghum (rather than imported malt). SABMiller is able to price this beer at levels below those of other clear beers in Uganda, Zambia and Zimbabwe, partly because it has obtained a reduction in excise duties from the governments involved. Andre Parker, managing director for its Africa and Asia division, says “The brand is reliant on the excise break, so we are working with the governments to lower the excise rate so that the retail price is below that of clear beer. The margin, though, is at least as good as our other brands” (Bolin, 2005). Eagle beer is profitable for SABMiller and a good example consistent with the BOP proposition, but it is probably detrimental to the overall welfare of poor consumers. Activist consumer organizations advocate higher (not lower) taxes on alcohol to support public education and rehabilitation programmes (for example, Assunta, 2001).

Is it in the self-interest of the poor to consume, and thus abuse, alcohol to do so? Should companies have the right to profit from such sales of alcohol to the poor? In rich economies, governments constrain right with “sin taxes”, restrictions on advertising, and sale to minors. Yet, in many developing countries, such constraints are missing, and even when they do exist, they are poorly enforced, especially when it comes to marketing alcohol to the poor. For example, in Malaysia, bottles of “samsu” (the generic name for cheap spirits) advertise outrageous claims that it is “good for health, it can cure rheumatism, body aches, low blood pressure, and indigestion. Labels also claim it is good for the elderly, and for mothers who are lactating” (Assunta, Idris and Hamid, 2001).

Even MNCs have got into the act. DOM Benedictine, which contains 40 per cent alcohol, claims health-giving and medicinal properties. Guinness Stout suggests it is good for health and male virility. Alcoholic drinks are easily available in coffee shops and sundry shops without a liquor license. Forty-five per cent of Malaysian youth under 18 consume alcohol regularly. In an ironic twist on the “single serve packaging” idea often championed by BOP advocates, samsu is available in small bottles of about 150 ml and “sold for as little as \$0.40–0.80. ... It is obvious that these potent drinks are packaged to especially appeal to the poor” (Assunta, Idris and Hamid, 2001).

Aside from the government, activist movements also play a role in protecting the consumer, but these are generally weak if not non-existent in most poor societies. Alcoholics Anonymous is a fellowship of men and women who share their experiences to help each other solve their common problem with

alcoholism. The poor in emerging economies usually do not have access to such rehabilitation programmes. In the USA in 1991, Heilman Brewery introduced PowerMaster, a malt liquor with high alcohol content, targeted at African American youth. A campaign led by African American leaders resulted in the product being withdrawn from the market within a few months. Such social mechanisms for consumer protection are often very weak in developing countries, and even more so for the poor. There is a need for checks and balances on powerful companies, especially MNCs, marketing to the poor. The romanticization of the poor as “value-conscious consumers” has resulted in too little emphasis on legal, regulatory, and social mechanisms to protect the vulnerable consumers. In the absence of such protective mechanisms, even companies that proclaim to be socially responsible do sell products to the poor that are of dubious value and probably harmful to the poor. I study below the example of Fair & Lovely, a skin whitening cream marketed by Unilever in 40 countries in Asia, Africa and the Middle East.

#### WHITENING CREAM<sup>1</sup>

Hammond and Prahalad (2004) cite the example of a poor sweeper woman who expressed pride in being able to use a fashion product, Fair & Lovely, a skin cream marketed by Unilever. “She has a choice and feels empowered.” One TV advertisement for Fair & Lovely aired in India “showed a young, dark-skinned girl’s father lamenting he had no son to provide for him, as his daughter’s salary was not high enough—the suggestion being that she could not get a better job or get married because of her dark skin. The girl then uses the cream, becomes fairer, and gets a better-paid job as an air hostess—and makes her father happy” (BBC News, 2003). The All India Democratic Women’s Association campaigned against this and another advertisement as being racist, discriminatory, and an affront to women’s dignity. This campaign culminated in the Indian government banning two Fair & Lovely advertisements. Ravi Shankar Prasad, India’s Minister of Information and Broadcasting, said “Fair & Lovely cannot be supported because the advertising is demeaning to women and women’s movement” (*The Economic Times*, 2003).

Indian society, like many others, unfortunately suffers from racist and sexist prejudices. This leads many women to use skin lightening products, sometimes with negative health side effects (Browne, 2004). Hammond and Prahalad (2004) argue that the poor woman “has a choice and feels empowered because of an affordable consumer product formulated for her needs”. This is no empowerment! At best, it is an illusion; at worst, it serves to entrench her

disempowerment. Women's movements in countries from India to Malaysia to Egypt obviously do not agree with Hammond and Prahalad, and have campaigned against these products. The way to truly empower a woman is to make her less poor, financially independent, and better educated; we need social and cultural changes that eliminate the prejudices that are the cause of her deprivations.

Should women have the right to buy Fair & Lovely? Yes. Should Unilever have the right to make profits by selling these products? Yes; Unilever after all did not create the prejudices that feed the demand for this product. Yet, it is likely that the company helps to sustain these prejudices, however unwittingly. In any case, we should impose some constraints on this right in terms of truth in advertising, full disclosure of ingredients in the product and its potential side effects. Even in rich capitalist countries, governments impose restriction on free markets to protect consumers in various ways, such as regulations related to labelling disclosure, truth in advertising, and marketing to minors. Consumer movements are active in areas where there are no legal restrictions, such as the recent pressure on McDonald's to introduce healthful meals. Such consumer protection, both legal and social, is inadequate in the developing countries. This is even truer in the context of selling to the poor, who often lack the information and education needed to make well-informed choices.

The BOP proposition is not satisfied with just giving the company the right to sell skin whitening cream. It goes further and commends the company for empowering women and helping eradicate poverty. This position is morally problematic.

#### THE POOR AS AN ATTRACTIVE MARKET

The growing appeal of the BOP proposition has been fuelled by the argument that poor people represent a large and lucrative market. Prahalad (2005) argues that the poor, defined as people living on less than \$2 per day, at purchasing power parity (PPP) rates, represent a market size of PPP\$13 trillion. Allen Hammond, vice president of World Resources Institute (WRI) and a leading advocate of the BOP proposition, asserts that "the buying power of these poorer markets weighs in at a staggering \$15 trillion a year" (Wall, 2006). Given such large estimates, it is not surprising that the BOP proposition has become so popular.

In a 2006 article,<sup>2</sup> I argued that such BOP market estimates are gross exaggerations. Using rough calculations from then available World Bank data, I estimated the BOP market to be \$1.2 trillion at PPP, and \$0.3 trillion at

current exchange rates, in 2002. From the perspective of multinational companies, the BOP market size is \$0.3 trillion, since companies necessarily convert local currencies into the home currency at exchange rates. In response to my article, Prahalad insisted, in an interview published in *Fast Company* in March 2007, that he had not overestimated the size of the BOP market.

We now have new data to resolve this debate. The report *The Next 4 Billion*, released in 2007 by the International Finance Corporation (the private sector arm of the World Bank group) and WRI, estimates the size of the BOP market based on unique (and previously unreleased) access to the household surveys of 146 developing and transition countries.

I have calculated the BOP market in 2002 using data from *The Next 4 Billion* for a poverty line of \$1000 at PPP (which roughly corresponds to the commonly used \$2 per day in 1990 prices standard). In that case, the global BOP market size is only \$0.36 trillion at market exchange rates, which is remarkably close to my earlier estimate. The headline of *The Next 4 Billion* is “New Analysis reveals \$5 Trillion Market at Base of Pyramid”. The report arrives at such a high estimate by defining the poverty cut-off level at \$3,000 PPP, which is much higher than any commonly used poverty line. According to this report, 98.6 per cent of the population in India is in the “bottom of the pyramid”!

The allegedly large and lucrative market at the bottom of the pyramid is a mirage. Fuelled by rapid economic growth, the shape of the economic pyramid is changing in many developing countries, leading to the rapid emergence of a middle class. Companies seeking new profit opportunities are much better off targeting this vast new pool of consumers—the fast growing middle class—in the emerging economies, especially China and India.<sup>3</sup>

The BOP literature often confuses the emerging middle class for the poor. Virtually none of the examples cited by BOP proponents support the recommendation that companies can make a fortune by selling to the poor (Karnani, 2007a). Several of the examples that apparently support the BOP proposition involve companies that are profitable by selling to the middle class in developing economies, although even these consumers seem poor to a Western researcher.

This romanticizing the poor as being more affluent than they really are is harmful to both companies and the poor. Companies following the BOP proposition often fail because they overestimate the purchasing power of poor people and set prices too high, and overestimate the market size. Karnani (2007a) describes the case of Coca Cola in India launching its low-price, affordability strategy, which hinged on raising the overall consumer base by offering carbonated soft drinks in smaller pack sizes of 200 ml at Rs. 5, which



is equivalent to \$0.57 (at PPP). People living on less than \$2 per day do not find this to be “affordable”. Coca Cola’s BOP initiative is certainly not helping the poor. Nor is it helping Coca Cola. Facing declining profits, the company reversed this low-price strategy in 2004. Unilever had a similar experience in the ice cream business in India (Karnani, 2007a).

More importantly, confusing together the middle class and the poor harms the poor by leading to ineffective poverty alleviation policies. Muhammad Yunus (1998) cautions against overly broad definitions of “the poor” and argues that there is no “room for conceptual vagueness” if poverty alleviation efforts are to be effective. Yunus (1998) states clearly:

*The inability to reach the poorest of the poor is a problem that plagues most poverty alleviation programs. As Gresham’s Law<sup>4</sup> reminds us, if the poor and non-poor are combined within a single program, the non-poor will always drive out the poor. To be effective, the delivery system must be designed and operated exclusively for the poor. That requires a strict definition of who the poor are—there is no room for conceptual vagueness.*

#### THE POOR AS ENTREPRENEURS

Many poor people are entrepreneurs in the literal sense: they are self-employed, raise the capital, manage the business and are the residual claimants of the earnings. But, the current usage of the word “entrepreneur” requires more than a literal definition. Entrepreneurship is the dynamic engine of Joseph Schumpeter’s concept of “creative destruction”. An entrepreneur is a person of vision and creativity who converts a new idea into a successful innovation, into a new business model. Some poor people are certainly true entrepreneurs, and have created thriving businesses—these are the subjects of heart-warming anecdotes. But, the empirical evidence suggests that the vast majority of the poor lack the skills, vision, creativity and drive also needed for entrepreneurial success due to their unfortunate circumstances.

Banerjee and Duflo (2007) argue that the poor have a “reluctance to psychologically commit themselves to the project of making as much money as they can”. In a study of farmers in Kenya, Duflo, Kremer and Robinson (2006) find that few farmers use fertilizers, even after the benefits—average return on investment of over 100 per cent—have been demonstrated to them. Not many Ghanaian farmers cultivate pineapples which would achieve returns of 250–300 per cent (*The Economist*, 2007a). This is perhaps understandable: the poor face such bleak circumstances that they come to believe the future

is hopeless. Almost a century ago, George Orwell wrote that poverty “annihilates the future”—that bleak trenchant observation is just as valid today.

The vast majority of the self-employed poor are stuck in subsistence activities with no prospect of competitive advantage. The self-employed poor usually have no specialized skills and often practice multiple occupations (Banerjee and Duflo, 2007). Many of these businesses operate at too small a scale. The median business operated by the poor has no paid staff; most of these businesses have very few assets as well. With low skills, little capital and no scale economies, these businesses operate in arenas with low entry barriers and too much competition; they have low productivity leading to meagre earnings that cannot lift their owners out of poverty. There is no evidence to support Prahalad’s (2005) assertion that (all) the poor are “resilient and creative entrepreneurs”.

This should not be too surprising. Most people do not have the skills, vision, creativity, and persistence to be true entrepreneurs. Even in developed countries, with higher levels of education and infrastructure, about 90 per cent of the labour force are employees, rather than entrepreneurs (International Labour Organization, 2007). Even with the greater availability of financial services in developed countries, only a small fraction has used credit for entrepreneurial purposes. Most poor people are not self-employed by choice and would gladly take a factory job at reasonable wages if possible. The romanticized portrayal of the poor as “resilient and creative entrepreneurs” is far from accurate, and a misleadingly poor basis for effective poverty reduction measures. The International Labour Organization (ILO) uses a more appropriate term: “own account workers.”

#### BOP PROPOSITION UNDER-EMPHASIZES THE ROLE OF THE STATE

In recent decades, the world has seen a decisive ideological shift towards an increased role for markets. There is a growing “neo-liberal” movement which seeks to reduce the role of the state and to “marketize” all public sector functions. In particular, the BOP proposition argues that the private sector should play the leading role in poverty reduction (Prahalad, 2005). This is a dangerous delusion because it grossly under-emphasizes the role and the responsibility of the state in poverty reduction.

Contrary to the BOP proposition, the empirical evidence supports a larger role for the state in providing social services in developing countries. Pattanayak (2006) calculates the public expenditure on education as a percentage of GNP for developed countries to be 5.46 per cent in 1980 and 5.54 per cent in 1997;

the comparable numbers for developing countries are 3.99 per cent and 3.92 per cent. World Bank (2006) data indicate public education expenditure to be 5.6 per cent of GDP for developed countries and 4.1 per cent for developing countries in 2004. Similarly, public health expenditure accounted for 6.7 per cent of GDP in 2004 in high-income countries compared to 1.3 per cent in low income countries. Governments in developing countries need to play a larger role in education and public health.

Prahalad and Hammond (2002) describe the impressive extent of business activity in the slums of Dharavi (in Mumbai), claiming “the seeds of a vibrant commercial sector have been sown”. They argue that the poor accept that access to running water is not a “realistic option”, and therefore spend their income on things that they can get immediately to improve the quality of their lives. Prahalad has said “if people have no sewage and drinking water, should we also deny them televisions and cell phones?” (*Time*, 2005). This opens up a market, and the BOP proposition urges private companies to make profits by selling to the poor. (This chapter focuses on poverty alleviation, not profit maximizing strategies for firms; however, this advice to companies is riddled with fallacies—see the appendix.)

But we should be cautious about celebrating this entrepreneurship too much and romanticizing the poor. In her emotive book about Dharavi, Sharma (2000) states that while enterprise in the midst of deprivation is to be admired, there is absolutely “nothing to celebrate about living in a cramped 150 sq. ft. house with no natural light or ventilation, without running water or sanitation”. UN-Habitat estimates that in Dharavi there is one public toilet for every 800 people. Writing about the slums of Kibera (in Nairobi), *The Economist* (2007b) observed, “most striking of all, to those inured to the sight of such places through photography, is the smell. With piles of human faeces littering the ground and sewage running freely, the stench is ever-present”.

The real issue which the BOP proposition glosses over is: why do the poor accept that access to running water is not a “realistic option”? Even if they do, why should we all accept this bleak view? Instead, we should emphasize the failure of government and attempt to correct it. By emphatically focusing on the private sector, the BOP proposition detracts from the imperative to correct the failure of the government to fulfil its traditional and accepted functions such as public safety, basic education, public health, and infrastructure. There is no alternative viable mechanism for achieving these results.

The downside of the BOP proposition can be illustrated by the metaphor of a seriously wounded person being tended by an ineffective doctor (either incompetent or corrupt or both). A Good Samaritan is appalled by the situation

and takes charge, putting a band-aid on the patient. The Samaritan feels good about his own actions. Meanwhile, the doctor walks away, thinking somebody else is now responsible for the patient. A BOP consultant advises the Samaritan to start a business selling band-aids. The patient continues to deteriorate.

## CONCLUSION

A libertarian movement that emphasizes free markets to reduce poverty has grown strong in recent years, attracting the attention of business executives, academics, and public officials. This approach explicitly views the poor as “resilient and creative entrepreneurs and value-conscious consumers”. This romanticized view of the poor is far from the truth and harms the poor in two ways. First, it results in too little emphasis on legal, regulatory, and social mechanisms to protect the poor who are vulnerable as consumers. Second, it results in over-emphasis on micro-credit and under-emphasis on fostering modern enterprises that could provide decent employment opportunities for the poor. More importantly, the BOP proposition grossly under-emphasizes the critical role and responsibility of the state for poverty reduction. Support for the BOP proposition is intellectually problematic while the implications of the BOP proposition are morally problematic. The BOP approach relies on the invisible hand of the free market to alleviate poverty. We should instead require the state to extend a very visible hand to the poor to help them climb out of poverty.

Table 6.1:

**FORTUNE OR MIRAGE AT THE BOTTOM OF THE PYRAMID (BOP)?**

**Fortune at the BOP:** Large multinational companies can make a fortune by selling to poor people at the bottom of the pyramid.

**Mirage of a Fortune:** The alleged large and lucrative market at the bottom of the pyramid is a mirage, and companies are much better off targeting the growing middle class in emerging economies.

<b>Fortune at the BOP</b>	<b>Mirage of a Fortune</b>
BOP market size is \$13 to \$15 trillion.	BOP market size is only \$0.36 trillion.
There is much “untapped” purchasing power at the BOP.	The poor have low savings rates, and little “untapped” purchasing power.
Profit margins in BOP markets are high.	BOP markets are not so profitable because customers are price sensitive, and the cost of serving them is high, given the small size of transactions and poor infrastructure.
The poor often buy “luxury” items.	The poor spend 80 per cent of their meagre income on food, clothing, and fuel alone, leaving little room for luxuries.
Companies should reduce prices dramatically without reducing quality.	A significant improvement in technology could reduce prices dramatically without reducing quality, such as in computers, telecommunications and electronics. But in most other product categories, the only way to reduce prices significantly is to reduce quality. The challenge is to do this in a way that the cost-quality trade-off is acceptable to the poor.
Single serve packages increase affordability.	Single serve packages do increase convenience and help the poor to manage cash flow. But the only way to increase real affordability is to reduce the price per use.
Large MNCs should take the lead role in the BOP initiative to sell to the poor.	Markets for selling to the poor usually do not involve significant scale economies, and small- to medium-sized local firms are better suited to exploiting these opportunities.

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## NOTES

- 1 For a longer discussion of this topic, see Karnani (2007b).
- 2 Since published as Karnani (2007a).
- 3 See, for example, McKinsey Global Institute (2006, 2007).
- 4 Here, it refers to the tendency of one group to “crowd out” another’s ability to gain benefits from a programme.

## Chapter 7

# How Effective is Microfinance as a Poverty Reduction Tool?<sup>1</sup>

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ANIS CHOWDHURY

*There are many stories of the transformative effect of microfinance on individual borrowers but **until recently** there has been surprisingly little **rigorous** research that attempts to isolate the impact of microfinance from other factors, or to identify how different approaches to microfinance change outcomes.*

(Center for Global Development, 2007; emphasis added)<sup>2</sup>

Professor Mohammad Yunus, the founder of Grameen Bank in Bangladesh and the originator of the concept of microfinance, believes that 5 per cent of Grameen Bank's clients exit poverty each year.<sup>3</sup> However, there are surprisingly few credible estimates of the extent to which microcredit actually reduces poverty. Even the *recent* more *rigorous* research findings are not free of methodological limitations or controversies.<sup>4</sup> Thus, the continuing intense debate about the impact of microfinance on poverty reduction is not surprising. Despite the euphoria of the Nobel Peace Prize going to Professor Mohammad Yunus, there are still many sceptics.<sup>5</sup>

Ideally one can ascertain the impact of microfinance if the counter-factual—what would have happened to a person who borrowed from a microlender if he/she had not done so—can be easily tested. Many early studies compared borrowers with non-borrowers. But if borrowers are more entrepreneurial than those who do not borrow, such comparisons are likely to grossly overstate the effect of microcredit. Two recent studies attempted to overcome the problem of self-selection (i.e., the likelihood of people with entrepreneurial skills borrowing) by using randomized sample selection methods (Banerjee, Duflo, Glennerster and Kinnan 2009; Karlan and Zinman 2009). That is, participation in a programme is determined essentially by chance. Contrary to the usual claims, neither study found that microcredit reduced poverty.



Microcredit may not even be the most useful financial service for the majority of poor people (*The Economist*, July 16, 2009). The MIT study by Banerjee, Duflo, Glennerster and Kinnan (2009) found no impact on measures of health, education, or women's decision-making among the slum dwellers in the city of Hyderabad, India. Similarly, the study by Karlan and Zinman (2009), which measured the probability of being below the poverty line and the quality of food that people ate, found no discernible effects.

## THE STATE OF THE DEBATE

### *Impacts on Poverty Reduction*

The most-cited source of evidence on the impacts of microfinance is the early set of studies collected by David Hulme and Paul Mosley (1996). The findings of these studies are provocative: poor households do not benefit from microfinance; it is only non-poor borrowers (with incomes above poverty lines) who can do well with microfinance and enjoy sizable positive impacts. More troubling is the finding that a vast majority of those with starting incomes below the poverty line actually ended up with less incremental income after getting micro-loans, as compared to a control group which did not get such loans.

Findings of the Hulme and Mosley studies imply that credit is only one factor in the generation of income or output. There are other complementary factors, crucial for making credit more productive. Among them, the most important is recipient's entrepreneurial skills. The findings of the MIT study by Banerjee *et al.* also point to this factor.<sup>6</sup> Most poor people do not have the basic education or experience to understand and manage even low level business activities. They are mostly risk-averse, often fearful of losing whatever little they have, and struggling to survive.<sup>7</sup> This does not mean that they do not want to better themselves (e.g., as suggested by the so-called backward bending labour supply curve).

Aneel Karnani (2007: 37) summarizes this point as follows: "Most people do not have the skills, vision, creativity, and persistence to be entrepreneurial. Even in developed countries with high levels of education and access to financial services, about 90 percent of the labor force is employees, not entrepreneurs". According to Vijay Mahajan (2005), a social entrepreneur and chairman of BASIX, "Microcredit is a necessary but not a sufficient condition for microenterprise promotion. Other inputs are required, such as identification of livelihood opportunities, selection and motivation of the microentrepreneurs, business and technical training, establishing of market linkages for inputs and outputs, common infrastructure and some times regulatory approvals. In the

absence of these, micro-credit by itself, works only for a limited familiar set of activities—small farming, livestock rearing and petty trading, and even those where market linkages are in place”. Robert Pollin (2007: 2) has a similar view, and puts it in the following words: “Micro enterprises run by poor people cannot be broadly successful simply because they have increased opportunities to borrow money. For large numbers of micro enterprises to be successful, they also need access to decent roads and affordable means of moving their products to markets. They need marketing support to reach customers”.

As a matter of fact, most promoters of microfinance do not wholly disagree that microfinance alone cannot do the job. For example, Sam Daley-Harris, Director of the Microcredit Summit Campaign, writes, “Microfinance is not the solution to global poverty, but neither is health, or education, or economic growth. There is no one single solution to global poverty. The solution must include a broad array of empowering interventions and microfinance, when targeted to the very poor and effectively run, is one powerful tool”. (2007: 1). In the words of Professor Yunus (2003: 171; emphasis added), “Micro-credit is not a miracle cure that can eliminate poverty in one fell swoop. But it can end poverty for many and reduce its severity for others. *Combined with other innovative programs* that unleash people’s potential, micro-credit is an essential tool in our search for a poverty-free world.”

Thus, there is broad agreement about the need for complementary factors for microfinance to have some positive impact on poverty reduction. The supply of microcredit does not necessarily ensure the availability of complementary factors in adequate quantities and quality. Some microfinance institutions and non-government organizations (NGOs) seem to have understood the need for such factors and, therefore, also offer training to build management and entrepreneurial skills. There are also NGOs (such as BRAC in Bangladesh) which provide basic education in rural areas using innovative methods. These are all potentially positive developments for poverty reduction efforts.

But the focus has been generally on supply side factors which complement one another to make micro investment productive. Very little attention has been paid to the demand side, except perhaps for Pollin (2007: 2) who notes that microenterprises “need a vibrant, well-functioning domestic market itself that encompasses enough people with enough money to buy what these enterprises have to sell. Finally, micro businesses benefit greatly from an expanding supply of decent wage-paying jobs in their local economies. This is the single best way of maintaining a vibrant domestic market”.

Moreover, as pointed out by Milford Batemen and Ha-Joon Chang (2009: 7), microfinance ignores the crucial potential of scale economies. In the absence of an expanding economy, “microenterprises are forced to survive

by drastic cost-cutting strategies, which in the short run can take crucial market share away from local SMEs that might otherwise be able to reduce unit costs and register productivity growth in the long run”.<sup>8</sup> This involves two distinct criticisms. First, an exclusive focus on microfinance may be at the expense of more “inclusive finance”, i.e. depriving SMEs and other credit-starved producers, as there are a range of enterprises needing credit facilities other than those already well served.

Second, microfinance tends to encourage an over-supply of inefficient microenterprises that may undermine the emergence and development of more efficient and potentially internationally competitive larger enterprises. Too many microenterprises, due to a constant inflow of new MFI financed entrants, may cause “market saturation” and “cut-throat” or “beggar thy neighbour” hyper-competition. This results in very low, and declining rewards for simple microenterprise activities as there are few entry barriers to such activities characterized by market conditions most closely approximating perfect competition. As pointed out by Osmani (1989), such constant new entry may also push down returns in incumbent microenterprises to below the cost of borrowing.

Without an expanding domestic market, a new enterprise in the midst of too many microenterprises would be like a moral tale. Two partners jointly set up a grocery shop. They are very excited about their prospects for becoming rich. But their enthusiasm gradually wanes as they wait for their first customer who never shows up. One of them finds a solution. She borrows some extra money and buys from the shop. This generates some income for her partner, who uses this to buy from the shop. This buying and selling from each other continues until the stock finishes. In the process, they may smooth their consumption, but end up with greater debt!

This may be a tragic-comic story, but does have an important lesson.<sup>9</sup> That is, without a vibrant domestic market, micro financed businesses will most likely replicate a barter economy. But with credit coming in between to facilitate transactions, the parties can even become worse off in extreme cases of a stagnant market.<sup>10</sup> Therefore, it is not surprising that a World Bank sponsored study, involving 1,800 households in Bangladesh, found only very marginal improvements for borrowers of microcredit (Khandker 2005). For example, the incomes of women who received micro-credit increased by only 8 *taka* for each 100 borrowed. Commenting on this finding, David Roodman and Uzma Qureshi (2006: 38) write, “Thus a \$250 one-year loan would raise a borrower’s income by \$12.50/year, or about \$0.03/day. For someone living on \$2/day, that is a 1.5 per cent increase. This does not live up to the micro-finance hype”.<sup>11</sup>

This modest income gain happened in the context of rapidly expanding garments production in Bangladesh. The World Bank study compared households in the sample between 1991–1992 and 1998–1999. Then it would have been an interesting counter-factual to see what would have happened in the absence of the fast expanding garments industry in Bangladesh.

Consideration of demand side factors highlights the importance of pro-growth macroeconomic, trade and industry policies. Bangladesh was at the height of pursuing neo-liberal policies during the period the World Bank study covered. Following the renewal of IMF's structural adjustment loans in the early 1980s, Bangladesh followed contractionary macroeconomic policies aimed at reducing the budget deficit and inflation.<sup>12</sup> The policy framework did not change with the democratically elected governments in the 1990s. Although the inflation rate fell from around 9 per cent in the latter half of the 1980s to around 4 per cent in the first half of the 1990s, GDP growth remained at around 4 per cent.<sup>13</sup> The average real lending interest rate during the 1990s was over 8 per cent, compared to about 4.5 per cent in the previous decade (Ahmed and Islam 2006). Thus, private investment in real terms declined from 12.1 per cent of GDP during 1980–1985 to 11.3 per cent during 1991–1995. It is quite easy to understand why the overall investment rate can stagnate under a monetary policy regime with a conservative ceiling on overall credit growth, as the expansion of micro-credit must be matched by the contraction of credit to others (e.g., SMEs) to meet the overall credit growth limit.

Policy contraction was also applied on the fiscal side, which saw a reduction in the government budget deficit from around 6 per cent of GDP in the latter half of 1980s to around 4.5 per cent in the first half of 1990s. The result was stagnation of public investment which remained around 6.5 per cent of GDP from the mid-1980s through the 1990s. Thus, not only was demand constrained, but also the stagnation of public investment meant supply side factors—such as roads, electricity and other essential infrastructure—crumbled. Fortunately, the garments sector still managed to grow, thanks to the resilience and ingenuity of the entrepreneurs in Bangladesh, and to the buoyant world economy.

In response to the modest findings in terms of monetary measures of poverty (head-count ratios of people living under the poverty line), advocates of microfinance—for example, Sam Daley-Harris and Felicia Montgomery—cite impressive social progress (reduced infant and maternal mortality, fall in the fertility rate and increased school enrolment ratios, especially of females) in Bangladesh. But can these achievements be attributed to microfinance? Sri Lanka was a star performer in social progress long before the microfinance movement started. In recent times, Andhra Pradesh in India has also performed

much better than the rest of India in terms of social indicators of development. Microfinance does not seem to have played a big role there either.

In sum, microfinance is not a panacea for poverty reduction, which needs both complementary supply-side and demand-side factors. Supply-side factors—such as good infrastructure, entrepreneurial skills, etc.—are needed to make microenterprises more productive. But the potential for increased productivity will remain mostly unrealized in the absence of demand-side factors. In other words, without a supportive macroeconomic, trade and industry policy framework, microenterprises will remain micro, with no backward or forward linkages or employment creation possibilities. This is the crux of the so-called graduation problem of micro-borrowers, as highlighted in a recent editorial in the *Daily Star* (Dhaka, December 12, 2008): “so long as this is not complemented by the government’s facilitating growth of marketing network, reliable energy supplies and a dose of fiscal incentives to the small exporters, the full potential of the micro-credit sector would remain untapped”.

### *Returns to Investment and Interest Rates*

More than anything else, the interest rates charged by microfinance institutions (MFIs) draws most vigorous criticisms. There are claims of interest rates ranging from 30 to 100 per cent on an annualized basis. Jonathan Morduch (2008) reports a survey of 350 leading microfinance institutions which charged between 20 and 40 per cent per year after taking inflation into account. Some (e.g., Nimal Fernando of the Asian Development Bank, Armendariz Achion and Jonathan Morduch) defend the high rates on grounds of sustainability. According to them, anything less will not attract profit-seeking bankers into this market. However, this argument weakens the claim that microfinance is more cost effective compared to commercial banking loans because of: (a) lower information gathering and processing costs, and (b) higher repayment rates requiring less provisioning for bad loans.

Where the interest rate is at the lower end, it is often due to implicit subsidies. Based on in-depth case studies, Pankaj Jain and Mick Moore (2003: 10), observe, “all five programmes we studied obtained subsidized funds for initial capitalization and, in many cases, for meeting part of the operating costs”. Jonathan Morduch’s (2000) panel discussion with senior and experienced donors and NGO representatives in Colombia suggests that not more than 5 per cent of microcredit programmes world-wide could become financially viable without subsidy. Despite growing interest from private investors, 53 per cent of the \$11.7 billion that was committed to the microfinance industry in 2008 still came at below-market rates from aid agencies, multilateral banks

and other donors (*The Economist*, July 16, 2009). This, then, raises the issue of the social opportunity cost of subsidies. Vijay Mahajan (2005) puts this argument forcefully: “If the implicit subsidies to microcredit institutions are made explicit, then subsidizing microcredit programmes versus subsidizing social sector programmes can become an informed policy choice, rather than be carried out under the mistaken notion that the former will require only temporary and diminishing subsidies. But the implicit subsidies to microcredit, legitimate as they may be, are not being described or analysed”.

Thus, some proponents defend this by arguing that it is still less onerous than the alternatives. For example, according to Karol Boudreaux and Tyler Cowen (2008), “That’s not as scandalous as it sounds—local money-lenders demand much higher rates.” Others defend the high interest rates by claiming that the returns to capital are, indeed, high in microenterprises. But Jonathan Morduch (2008: 1), an advocate of microfinance, makes an important, but moot acknowledgement: “The microfinance movement rests largely on one basic *assertion*: that poor households have high economic returns to capital” [emphasis added].

Morduch also reports some recent research findings of high returns to capital ranging from 20 to 33 per cent per month for small, male-owned retail businesses with no employees other than the owner. Estimated returns to capital for the financially constrained businesses, according to these researchers, are even higher, ranging from 70 to 79 per cent per month. Based on these findings, Morduch (2008) concludes that even an interest rate of 10 per cent per month would be reasonable.

However, these findings have their own limitations, which Morduch himself admits. First, they do not say anything about female-owned businesses and hence, do not corroborate the popular claim that microfinance is particularly better for female borrowers. Second, and more importantly, one is not sure how these studies impute the cost of own labour. In an economy characterized by surplus labour, as in Bangladesh, where disguised unemployment in rural areas can be widespread, one can impute a zero shadow price for own labour.<sup>14</sup> In that case, the entire surplus over and above the cost of capital can be regarded as profit or returns to capital. This can be the most plausible explanation for the findings of high returns to microenterprises, such as from selling milk or eggs. The valuation of own labour at a zero shadow wage, coupled with high interest rates, essentially means that free labour accrues to capital.

Ideally, own labour should be priced at a “decent” or legislated minimum wage to enhance poverty reduction. Employment (self or otherwise) at a wage below a decent rate only adds to the pool of “working poor”. Earning a few extra cents may be a “big step forward” for a person living on less than

\$2 a day, as claimed by Karol Boudreaux and Tyler Cowen, but does not generate enough profit for reinvestment to grow his/her business. He/she still remains part of working poor, and perhaps even more vulnerable to shocks due to the debt burden. Thus, this can be another explanation for the so-called graduation problem of microenterprises, or why so many loans need to be rescheduled or refinanced as reported by the *Wall Street Journal*.<sup>15</sup>

## EXPLAINING THE EXPANSION OF MICROFINANCE

*The UN's 2005 'Year of Microcredit' marked the long journey of microcredit from an obscure experiment in the mid-1970s to the status of a worldwide movement. Microcredit has captivated not just the entire development aid industry, but journalists, editorial writers, policy makers and much of the general public in both the North and the South. Virtually every development project I see these days, from maternal and child health, to women's education, to soil conservation, to social forestry, to old fashioned integrated rural development, has a 'microcredit component', and everyone from camel herders in Mauritania to peasants in rural China can speak the lingo.* (Dichter, 2006)

If the poverty reduction impact of microfinance is so doubtful, how can one explain the movement's phenomenal expansion over a short period of three decades? The microfinance movement is enjoying tremendous support from both bilateral and multilateral donors. The movement climaxed with the Microcredit Summit, held in Washington, DC, on February 2–4, 1997, when 2900 delegates from 137 countries attended. According to the estimate of Microfinance Summit Campaign, there are now more than 3000 microfinance institutions, serving more than 100 million people in developing countries. The total cash turnover of these institutions world-wide is estimated at \$2.5 billion. The success of microfinance has now even attracted big mainstream commercial financial institutions, such as Morgan Stanley, Deutsche Bank and Citigroup.

Pankaj Jain and Mick Moore of the Institute of Development Studies (UK) and David Roodman and Uzma Qureshi of the Center for Global Development (USA) have attempted to explain the microcredit movement's rapid growth and international support. Based on an extensive survey of the literature and interviews with its leading players, Roodman and Qureshi (2006) claim that the success of microfinance is due to innovative business practices involving product design and management, and enabling environments. Roodman and

Qureshi (2006: iv) conclude, “Microcredit, like all credit, helps some people—one hopes, the majority of clients. And like all credit, especially when *pushed hard by suppliers*, microcredit must hurt some clients too. ... [T]he historical emphasis among MFIs on credit rather than savings appears to have arisen for practical business reasons rather than because it has been shown that credit helps clients more ... Microfinance investors should therefore work to understand how MFIs succeed on both bottom lines—as businesses and as agents of development” [emphasis added].

Roodman and Qureshi’s findings are similar to those of Jain and Moore (2003) who undertook extensive case studies of four leading microfinance institutions in Bangladesh (ASA, BRAC, Grameen and Proshika) and CARD in the Philippines. Jain and Moore found little evidence to support three core claims of microfinance movements: strong social bonds among small borrowers, substantial borrower participation in management and unsubsidized interest rates. According to them, the real explanation for their success lay in careful attention to managerial and strategic “fundamentals”. These include keeping transactions costs low, matching loan payment schedules to borrowers’ income and savings potentials, finding ways of obtaining good work performance from large and widely dispersed field staff, etc.

In addition to a business model explanation, Jain and Moore give a political economy explanation for the success of the microfinance movement. According to them, microfinance campaigners successfully projected the image of the movement, such as empowerment of women, which resonates well with the donor community. The birth of the movement roughly coincided with the rise of neo-liberal ideas in the US and the UK, and within the Bretton Woods institutions in the late 1970s and early 1980s. Thus, the notion that microfinance programmes are primarily engaged in the promotion of small scale enterprises appealed to major donors. While donors were wary of subsidized credit through state-owned specialized financial institutions, they were quite happy to subsidize microfinance institutions as they appeared to promote a market economy, and more importantly, they helped to diminish the role of the government. Jain and Moore (2003: 29) end their paper with a paradoxical note, “To properly appreciate the great achievements of the micro-credit movement, one has to be more sceptical of its self image than normally considered polite or respectful”.

In liquidity constrained societies, there is always demand for credit. So, when donor supported MFIs pushed the supply of credit, there was no shortage of takers. As a result, microfinance expanded exponentially. This seems to have created a mistaken belief among advocates of microfinance that supply creates its own demand *a la* Say’s law. The reality is that the supply of



credit and other complementary supply-side factors cannot drive the growth of viable businesses if the market itself does not expand rapidly. This can only create debt burden or under-utilization of credit and a downward pressure on the returns to investment.

There is a clear parallel in the labour market. In the early days, after independence, many countries invested heavily in higher and technical education. But as their overall policy framework failed to generate employment intensive growth, the supply oriented human resource policy only contributed to swelling educated or graduate unemployment. This not only amounted to wasteful under-utilization of graduates, but also contributed to the decline in returns to higher education due to over-supply.

#### ASSESSING THE CONTRIBUTIONS OF MICROFINANCE

Even a vocal critic like Thomas Dichter admits that microfinance can help the poor smooth consumption over periods of cyclical downturns or unexpected crises. This positive role of microfinance should not be dismissed altogether. If this consumption smoothing means parents can send their children to school, or buy essential medications, and maintain nutritional in-takes of their children then microfinance is likely to have positive long-term impacts on productivity. As noted by Partha Dasgupta (1995: 247), “At low levels of nutrition and health care, increase in current consumption improves future labour productivity: if nothing else, morbidity is reduced. For example, Pitt and Rozenweig (1985) observed from Indonesian data that an increase in the consumption of fish, fruit, or vegetables by 10 percent reduces the chances of illness there by 9, 3 and 6 percent respectively”.

Microfinance, thus, fulfils an important safety-net task, especially in countries where there is no state-sponsored social security system. In difficult times, the poor can first turn to family and neighbours. But in a situation of generalized poverty or economy-wide crisis, the poor will have to go to money lenders or to the employer/landlord for whom she or he works. If MFIs extend lending to the very poor in these circumstances then they can help break the power and hold of such creditors who operate in the inter-locking credit and factor markets.<sup>16</sup> Although high, the interest rates charged by the MFIs are lower than the rates charged by informal creditors (money lenders/employers/landlords).

Unfortunately, however, most MFIs have been found lacking when it comes to lending to the very poor. Nonetheless, it seems that microfinance has significantly dented the informal credit markets by undermining debt-bondage

and usury in some agrarian societies. Thus, microfinance is having a modernizing impact, even if inadvertent, unacknowledged and unsung.

More importantly, by “democratizing” the credit market the microfinance movement has not only curtailed the power of money lenders, but also constrained MFIs’ own behaviour. Some abuses of employees of MFIs, as reported by Aminur Rahman (1999), cannot be hidden under the carpet for too long. For example, when some MFIs’ officials went to collect repayments as part of their regular job immediately following the devastating cyclone Sidr in Bangladesh, this was widely reported in the national newspapers. As a result, the MFIs acted quickly to suspend loan recovery and to offer softer loan conditions.

In other words, the rapid expansion of microfinance has empowered not just women, but all small borrowers. Even if they do not participate effectively in MFIs’ decision making or management (as found by Jain and Moore), the ability of the MFIs to foreclose on any tangible property of loan defaulters seems to have shrunk significantly. So, one should not be surprised by the findings of the *Wall Street Journal*’s reporters that Grameen was often rolling over unpaid loans.<sup>17</sup> Whether Grameen was driven by any humanitarian consideration or forced to do so to avoid bad publicity is, of course, moot.

There is also the learning-by-doing effect. Even when own labour in micro-enterprises is given a zero shadow price, the people who are involved benefit. They learn some basic principles of business, and with luck, and perhaps some help, may be able to become more viable and even expand. This is akin to apprenticeship where the apprentice gets a low wage, but in exchange, gets training in a trade. So, with their support and training programmes, many MFIs are making some useful contributions.

Microfinance, thus, gives the unemployed and the poor some opportunities, hope and self-esteem. Being employed (whether self-employed or by an employer) gives a person a significant boost to his/her sense of self-respect and dignity. Furthermore, microcredit allows people to signal their credit-worthiness. If their success makes banks more willing to lend them larger sums and leads to even more economic activity, then that should help reduce poverty in the long run.

Finally, being successful business ventures, microfinance institutions themselves have also created a large number of good paying jobs. In the words of Roodman and Qureshi (2006: 39) “We should not lose sight of the fact that commercially successful microfinance institutions are remarkable organizations, employing hundreds or thousands of people at tasks once thought impossible.” Good jobs created by successful MFIs should have considerable multiplier effects.

Thus, beyond the “hype”, microfinance is making some important positive contributions to social transformation. However, many of these contributions cannot be measured in monetary terms, and hence will remain largely unacknowledged in the literature focused on the traditional income or expenditure measures of poverty. The question, nevertheless, remains as to how long microfinance can continue to provide consumption-smoothing support or extending the payments schedule. To be able to serve as a viable poverty reduction strategy, micro-credit financed enterprises must expand and create decent jobs for the growing labour force.

### CONCLUDING REMARKS

It is often claimed that the greatest discovery of the Grameen-led microfinance movement has been the credit worthiness of the poor. Related to this has been the discovery of the dynamism of microenterprises. In reality, however, neither is new. The poor have been borrowing from money lenders (landlords) from time immemorial. Microenterprises have been operating for a long time in many poor societies, and form the vast informal sector associated with developing countries. However, the real discovery is the concept of “group lending” which effectively overcomes the problems of collateral and adverse selection due to information asymmetry through peer monitoring.<sup>18</sup>

Impact analysis of microfinance suggests that the majority of borrowers who already have some assets (or business skills and education) are more likely to succeed. Therefore, when William Easterly (2006) refers to MFIs as “searchers”, the search should instead be for existing small enterprises in the informal sector, not the very poor without any assets or entrepreneurial skills. The danger of the hype over microfinance is that the needs of microenterprises in the informal sector may not get due attention. The owner operators of these microenterprises have already proven their entrepreneurial acumen, but they face numerous constraints ranging from inability to access the formal credit market to marketing their products. These enterprises should be supported with easy access to credit and other financial services (e.g., insurance).

Recognizing this, the United Nations has advanced the idea of “inclusive” finance as an integral part of financial sector development. To quote,

*There needs to be a continuum of financial services available to households as they increase their standards of living and for enterprises as they grow into the business mainstream. This is a critical*

*issue for the development of financial sectors. It involves adequate financial services for small and medium-sized enterprises (SMEs) often called the 'missing middle', as well as the smallest microentrepreneurs (United Nations, 2006: 6).*

Unfortunately, SMEs found themselves disadvantaged by neo-liberal financial sector reforms which have sought to promote profit-seeking financial institutions by eliminating state-run specialized financial institutions which catered for the needs of SMEs and the agricultural sector. As the UN (2006: 7) notes, “mainstream for-profit financial institutions have largely ignored the lower segment of the market. This includes SMEs, microentrepreneurs. ... Instead, these mainstream institutions have sought mainly high-value clients”. These high-value clients usually reside in urban areas while the majority of the poor people live in rural areas in developing countries.

The inefficiencies of many state-run specialized financial institutions have provided a strong rationale for market-based financial sector reforms. It is now realized that these reforms had their own limitations, while SMEs and the agricultural sector, especially food production, need state support. Therefore, instead of focusing solely on microfinance, designing efficient state-run specialized financial institutions as part of developing an inclusive financial sector should also be integral to the poverty reduction efforts. Management and operational lessons learnt from successful MFIs can provide valuable inputs into the design of specialized financial institutions for SMEs and the agricultural sector.

Access to financial services is, but, one aspect of the support needed by entrepreneurs running SMEs and microenterprises. They also need training in business skills and access to marketing information so that they can expand to take advantage of both domestic and international markets and thereby create decent jobs. Here too, the state has an important role to play as the majority of SMEs and microentrepreneurs will not be able to afford the market-determined fees for such training or marketing information.

In sum, while non-government organizations (NGOs) are making valuable contributions to safety-net by providing micro-credit to the poor and vulnerable, the state cannot abrogate its role in the area of social provision. The state also has to be a major player in the design and operation of an inclusive financial sector to cater for the needs of the “missing” middle in the informal and agricultural sectors. This is crucial to ensure that growth is employment-intensive to maximize its impact on poverty reduction.

## APPENDIX:

EMPLOYMENT GENERATION AS A POVERTY REDUCTION STRATEGY:  
LESSONS OF HISTORY

*if we take a closer look, we see something else—something alarming. In developing countries, excluding China, at least 100 million more people are living in poverty today than a decade ago. And the gap between rich and poor yawns wider* (Wolfensohn, 2000)

Ironically, this sombre acknowledgement from the former President of the World Bank comes after two decades of experiment with conservative macroeconomic policies and microfinance. With an unwavering faith in Say's law, the orthodox macroeconomic policy framework of the so-called Washington Consensus relegated the responsibility for growth and employment to supply side policies of microeconomic reforms. The rapid expansion of microfinance was expected to generate enough self-employment to compensate for job losses due to reforms, especially the roll-back of subsidized credit schemes to support SMEs and the agricultural sector. Income growth from microeconomic reforms and microfinanced enterprises was presumed to be sufficient to generate demand as long as governments maintained budget surpluses or zero deficits and low inflation (generally at less than 5 per cent). Trade liberalization was supposed to fill any shortfall in (or add to) demand as long as the government followed a flexible exchange rate regime with an open capital account. Hence, in this framework, there is no effective demand problem.

Interestingly, China, which according to Wolfensohn contributed most to the reduction of global poverty in recent decades, is not significant for microfinance. Nor did it follow the orthodox policy framework of the Bretton Woods institutions. During 1985-1997, the average rate of inflation in China was around 11 per cent and domestic credit grew at an average rate close to 25 per cent (average money supply growth was over 28 per cent). The average real lending rate was less than 1 per cent. It also followed a policy of an undervalued real exchange rate to support exports and to discourage imports. This mix of pro-growth monetary and exchange rate policies produced very rapid GDP growth of about 10 per cent for almost three decades which has helped reduce poverty despite growing inequality.<sup>19</sup> Furthermore, its restricted capital account shielded it from the 1997-1998 East Asian financial crisis.

Perhaps the socio-economic performances of Indonesia and Nigeria offer the best historical comparisons for poverty reduction. Both are large, populous developing countries with similar ethnic mixes of Muslims and Christians; they

were largely governed by military rulers from the mid-1960s until very recently. In 1973, both were roughly at the same level of development, measured in PPP\$; Indonesia's per capita GDP was PPP\$1504 compared with Nigeria's PPP\$1442 (Maddison 2001). Despite both enjoying windfalls from the oil price booms in the 1970s, their economic performances have diverged. By 1998, Indonesia's GDP per capita was three times that of Nigeria (PPP\$3070 vs. PPP\$1232). The result was a rapid reduction in poverty in Indonesia. \$1-a-day poverty in Indonesia dropped from 59 per cent in 1975 to 14 per cent in 1997, while economic stagnation in Nigeria meant an increase in \$1-a-day poverty from 35 to 70 per cent over the same period (World Bank 2008).

There are several explanations for Indonesia's impressive performance in the literature. While there are some disagreements about the role of liberalization and market reforms, all agree on the role played by the state in promoting labour (employment) intensive industrialization and agriculture with a variety of schemes. These included:

- massive investment in infrastructure, especially in rural areas and the outer islands, and in irrigation projects
- supply of subsidized agricultural inputs (in particular fertilizers)
- price support for rice farmers (through BULOG—a marketing board)
- rural savings and credit programmes (Bank Rakyat Indonesia—BRI)
- competitive real exchange rate through successive devaluations and managed depreciations.

In contrast to the microfinance movement, the rural credit scheme of Indonesia through the Bank Rakyat Indonesia (BRI) emphasized savings, not credit. Thus, by the end of 2005, BRI had 32.3 million deposit accounts and only 3 million loan accounts. The success of Indonesia highlights the role of domestic savings mobilization vis-à-vis credit. An expanding economy opens up the scope for productive investment, by small savers in a less risky environment. On the other hand, in a stagnant or slow growing economy, pushing credit can be quite risky for unsuspecting small borrowers.

One might argue that some other developing countries, notably India, also had some of the schemes (such as subsidized agricultural inputs and price support programmes) but still could not achieve the same success as Indonesia. But India largely succeeded with its agricultural policies to attain self-sufficiency in food as Indonesia; their performance varied in the industrial sector.

India, in following an import substituting industrialization (ISI) policy, was influenced by the Soviet model of heavy industrialization, which the celebrated Indian planner, P.C. Mahalanobis, described as “machine to produce machine”. Thus, the capital intensive ISI failed to create enough employment;

the domestic market did not grow rapidly to absorb the growing labour force while the industrial sector suffered from over-capacity. As such it was not the fault of ISI, but the capital-intensive nature of industrialization that failed. ISI can be followed equally for labour-intensive industries, and this is the lesson we learn from the experience of successful East and Southeast Asian economies (Chowdhury and Islam 1993; Jomo 2001).

The labour-intensive industrialization strategy has another advantage; it helps reduce income inequality. This is evident from Indonesia's experience. It did not undertake significant land reforms as Taiwan or South Korea, yet inequality in Indonesia declined remarkably; its Gini ratio declined from 0.41 in 1971 to 0.32 in 1990. The decline in inequality during the phase of rapid economic growth increased the growth elasticity of poverty reduction.<sup>20</sup>

The industrial strategy based on a model, “machine to produce machine” required an over-valued exchange rate to reduce cost of imports of industrial inputs. This, in turn, not only disadvantaged the agricultural sector, but also the industrial sector. Industries could not get rid of their excess capacity by exporting. India was one of the leading exporters among the developing countries of technologies (machinery) in the 1950s and early 1960s, but fell way behind other emerging countries in Asia by the 1980s (Lall 1982).

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## NOTES

- 1 Microfinance and micro-credit are used interchangeably here. However, in the literature, microfinance is also used in a broader sense to cover financial services such as micro savings and micro insurance.
- 2 "Evaluating the Impact of Microfinance" <http://www.cgdev.org/content/article/detail/12338/>, accessed on Dec. 4, 2008.
- 3 Quoted in *The Economist's* article, "A Partial Marvel", July 16, 2009.
- 4 See, for example, Morduch (2008) for a methodological critique of the Hulme and Mosley (1996) studies.
- 5 See "Debate on Microcredit", Foreign Policy in Focus, <http://www.fpif.org/fipifxt/4324>, accessed on Dec. 3, 2008. Among the prominent sceptics are Thomas Dichter, Aneel Karnani, Vijay Mahajan and Robert Pollin. Salil Tripathi wrote a sceptical editorial in *The Guardian* (October 17, 2006) a week after Professor Yunus was awarded the Nobel Peace Prize.
- 6 Households with an existing business at the time of the programme invest in durable goods, and their profits increase. Households with high propensity to become business owners see a decrease in nondurable consumption, consistent with the need to pay a fixed cost to enter entrepreneurship. Households with low propensity to become business owners see nondurable spending increase.
- 7 They are unlike Marx's proletariat who have nothing to lose but their chains. Instead, they are "protective".
- 8 In Bosnia, for example, many poor individuals signed up for microcredit in order to purchase cows to generate additional income from the sale of fresh milk. While this was widely seen as a very sensible and compassionate intervention by the international donor and NGO community, the outcome was extremely problematic. The local over-supply of fresh milk in many communities led to a general price decline. It also had a negative longer run effect by undercutting the day-to-day operations of potentially viable larger dairy farms. For example, it became more difficult to generate sufficient internal finance to reinvest in new stock and equipment (see Agripolicy 2006).
- 9 This story is not very different from the real life examples that Thomas Dichter gives where the microenterprises collapse or go nowhere due to the lack of an expanding market.

- 10 For example, the findings of the Hulme and Mosley studies and those cited by Mahajan and Karnani.
- 11 Roughly 81 per cent of the population of Bangladesh lives below the \$2 a day poverty line. The corresponding shares in Pakistan and Sri Lanka are about 70 and 40 per cent respectively.
- 12 See Mahmud (2008).
- 13 The Bangladesh economy grew at an average annual rate of 5.5 per cent between 1975/1976 and 1980/1981 when the average annual inflation rate was 9.5 per cent.
- 14 This is what the Lewisian model of surplus labour would dictate.
- 15 Two of its correspondents, Michael Philips and the late Daniel Pearl, suggested that Grameen was often rolling over unpaid loans and its non-performing loans were actually higher than investors were being told.
- 16 Inter-locking credit and factor markets is a feature of the semi-feudal agrarian relationship where farmers depend on their landlords for work (share-cropping) and credit. See Bhaduri (1973).
- 17 Jain and Moore (2003) also found the same with another large micro-credit organization, Proshika, in Bangladesh.
- 18 As a matter of fact, many leading microeconomic texts (e.g. Hal Varian, *Microeconomic Analysis*) cite this innovation in their discussion of asymmetric information and agency problem.
- 19 China followed a combination of expansionary and restrictive fiscal policy during this period; the overall budget deficit was only -1.7 per cent of GDP. Since the Asian crisis in 1997–1998, China has switched to a combination of restrictive monetary policy and expansionary fiscal policy; the overall budget deficit during 1998–2006 was slightly over 3 per cent of GDP, while growth of money supply (M2) and domestic credit slowed to around 16 per cent. The average inflation rate during the later period was 1 per cent and the average real lending rate was around 5 per cent.
- 20 Since the adoption of liberalization programmes in the late 1980s and early 1990s, the Gini measure of inequality has registered an increase. According to World Bank estimates, it was 0.363 in 2005. This phase (since 1993–1994) was also characterized by slow employment growth.

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# Chapter 8

## Property Rights for Poverty Reduction?

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RUTH MEINZEN-DICK

The links between poverty and (lack of) property rights are pervasive. It is not only that poor people lack current income, but they also lack assets with which to generate income. Millions of rural poor and the urban poor living in informal settlements lack access to land. But even when they have access to land, their rights, however understood, to the land may not be formally or legally recognized. Redressing this ambiguity through legislation to provide more secure land tenure for the poor thus seems to be a way to reduce poverty. However, experience shows that the apparent solution is not so straightforward. Land titling efforts that have not taken the complexity of property rights into account have backfired, actually reducing poor people's security of land tenure.

This chapter first reviews the links between property rights and poverty reduction, including the gender distribution of property rights. It then examines the plural nature of property rights, the relevance of multiple sources of claims on property, and how this complicates property rights reform. It then explores the implications for strengthening the property rights of the poor, and in particular, how understanding legal pluralism can lead to more effective policies and interventions to strengthen poor people's control over assets.

### PROPERTY AND POVERTY

Land is a critical asset, especially for the rural poor, because it provides a means of livelihood through the production and sale of crops and other products. For both the rural and urban poor, property rights over housing (on homestead land or other forms of housing) provide shelter, dignity, and a means for accumulation. Those without property rights generally lack the incentive or even the authority to make investments in the land where they live or farm that might lead to higher returns (Meinzen-Dick and Di Gregorio 2004). In many cases, land can be used as collateral for credit to invest in

the land, or be exchanged for capital to start up another income-generating activity. The landless are excluded from these opportunities, which is why they are often among the poorest. For example, data from South Asia, home to about 40 per cent of the world's poor, show that poverty is strongly associated with landlessness and insecure access to land. In India, over 30 per cent of the landless and near-landless (with less than 0.2 ha of rural land) live in poverty, and figures are even higher when they cannot migrate. In Bangladesh, those with less than 0.2 ha make up two-thirds of the poor. Moreover, research suggests that land ownership increases investment in the human development of children (Deere and Doss 2006). Therefore, property rights are particularly important in determining who has entitlements to food, and may serve as a means to perpetuate or break the inter-generational transmission of poverty.

In addition to being crucial for food security and stable livelihoods, land provides a buffer to smooth consumption in times of shocks. Land owners can sell or mortgage their land, which gives them more stability than the landless, who are less able to sustain the normal levels of consumption. Since these shocks also adversely affect the labour and food markets, those who have access to land can turn to their farm for self-employment and food production.

Beyond their economic importance, property rights—especially to land—fulfil a number of social functions. In many rural communities, land distribution is associated not only with the well-being of the household, but also with social standing in the community. Land owners are treated with greater respect and often feel a stronger sense of identity with the community. This position, in turn, shapes access to many government services, influence in local politics, participation in social networks and intra-household relations. For example, many water users' associations define membership in terms of land owners in the service area, which limits participation by other households who also need water (Meinzen-Dick and Zwartveen 1998). Extension agents focus their attention on land owners, which often excludes their wives, children, tenants and landless labourers.

It is not only the property rights of the household that matter: intra-household distribution, and especially differences between men and women, is also important. When women access land only through their husbands, fathers or sons, their tenure depends on their relationships with these men, and they are vulnerable to eviction and loss of land rights in cases of death of the man, divorce or disinheritance. Land ownership gives women greater bargaining power and stronger fallback options, which is one reason research in India has found that women who own land are less subject to domestic violence

(Panda and Agarwal 2005; Bhatla, Chakraborty and Duvvury 2006), a finding also supported by findings from Colombia (Friedmann-Sanchez 2006) and elsewhere in Latin America (Deere and Leon 2001). The increased bargaining power that confers on women control over resources, especially land tenure, also translates into a stronger voice in household decision making, which may contribute to stronger investments in food, education and schooling of children, with long-run consequences for poverty reduction (Deere and Doss 2006; Doss 2006).

As in the case of insecure tenure at the household level, women's lack of secure tenure can limit their access to credit, ability to invest in the land and its overall productivity. Women may be prohibited from planting trees on their "husbands' land" because it is seen as too much of a claim to that land, or they may be reluctant to plant trees or make long-term land improvements because they are not sure they will benefit (Fortmann and Rocheleau 1985). Research in Ghana shows that gender differences in property rights over land hinder sustainable management of tree resources, and that gifts/transfers of land to women improve cocoa productivity (Quisumbing and Otsuka, with others 2001).

#### CHANGING PROPERTY RIGHTS IN PLURAL LEGAL SYSTEMS

The strong links between poverty and tenure insecurity have prompted numerous land reforms. Redistributive land reforms that transfer land from large landlords to the landless, especially agricultural labourers, have a long history, especially in the latter half of the 20th century. Successful redistributive land reforms in East Asia did contribute to raising productivity in the region (FAO 2003) and rapid economic transformation (Kay 2002). But they require serious state commitment, to either expropriate land from large landowners or to identify resources for market-based redistributive approaches, and then additional resources to enable those who acquire land to use it productively.

Because redistributive land reforms have economic and political costs to acquire the land to be given to the poor, statutory reforms to provide greater tenure security on land they already occupy may seem a relatively easier way to confer property rights on the poor. In Africa, over 90 per cent of the rural population access land through customary mechanisms (Wily 2006). In the urban informal settlements in which millions of the poor live, people build homes on public or other land to which they do not have state-sanctioned rights. The formalization of land rights has a long history, and has often been advocated as an instrument for development and poverty reduction (e.g. Swynnerton 1954; de Soto 2000; CLEP 2008).

But a closer look at the experience of formalization reforms indicates that legislation and formal programmes do not necessarily change land tenure on the ground. This is because of the pervasiveness of legal pluralism, which gives rise to multiple sources of property rights and multiple claims on the benefit streams of a given asset (Griffiths 1986; Merry 1988; Meinzen-Dick and Pradhan 2002). Access and control of land and related resources such as water or trees do not only depend on statutory law, but also on a range of customary laws and other normative or legal frameworks. Understanding the complexity created by legal pluralism, and how different legal frameworks play out at the local level, is essential if any legal or programmatic interventions are to help the poor to strengthen their property rights. The remainder of this section discusses some of the critical aspects of pluralistic property rights that need to be considered in each context.

A starting point for analysis of property rights is to identify the legal frameworks that apply. Discussions often focus around a dichotomy between statutory and customary law, but property rights are also influenced by religious laws and practices, international treaties, development project regulations and a range of other legal or normative frameworks. For example, religious laws may designate certain land as sacred; watershed management projects may designate certain land as not for grazing or other specific uses. International treaties, such as the Convention on the Elimination of All Forms of Discrimination Against Women (CEDAW), specify that women should not be prohibited from holding property, but this may contradict clan rules about who is a member of the lineage, which influence who can inherit land. Local norms shape the interpretation of all of these, resulting in a mix of norms and rules expressed and used at the local level, called local law.

After identifying the different sources of property rights, a second step towards effective understanding is to look at how individuals and groups make use of one or another of these legal frameworks as the basis for their claims on a resource, in a process referred to as “forum shopping”. The choice of which frameworks each claimant employs will be affected by their knowledge of different types of rules, perceived contexts of interaction, power relations and expediency (Spiertz 2000: 191). Which law is accepted and enforced depends on power and social relationships between the different claimants.

As a result of this interaction of legal frameworks and the conscious and unconscious use of different bases of claims, property rights cannot be understood as simply deriving from statutes or formal rules. Rather, property rights and the uses of resources should be understood as negotiated outcomes (Meinzen-Dick and Pradhan 2002).

The persistence of legal pluralism does not imply that all laws are equally powerful. Rather, it is helpful to think of each type of law as having a “force field”, which may be strong in some contexts and weaker in others. In relations between government agencies and local communities, statutory law is usually more powerful and used by officials. Statutory law is also often used by outsiders to claim resources in ways that are not locally recognized as legitimate. But property rights are only as strong as the institution that stands behind the claim. If the state does not have much enforcement capacity and local community institutions, such as village, clan, caste, forest user group, or religious authority, are strong, then the latter may prevail. Thus, an outsider—or a local woman—claiming land based on state law may face social ostracism and not be able to use it effectively.<sup>1</sup> But where community institutions are either eroding (e.g. due to migration), or where the community itself is relatively weak and the state is strong, then people claiming land based on customary rights are likely to lose out to those with state-sanctioned claims.

To return to the force field analogy, when two legal frameworks are in harmony, they are mutually reinforcing. But when they diverge, they can counteract each other. In those cases, the enforcement capacity of each is important in determining the relative strength of different types of property rights claims. What this means is that if statutory reforms aim to bring about changes that are strongly opposed to customary or other types of rules, they will require considerable state implementation and enforcement capacity. Legal literacy campaigns are needed to make people aware of the new laws—from the general public to the government agencies administering it, to the justices who will be called to hear appeals cases. The administrators of the programmes (including the land registrars) will need to be accessible to poor men and women, which often means decentralized property registers, as well as enforcement authorities with enough information and capacity to ensure compliance at the local level. The difficulties in appropriating the resources to provide such decentralized administration and enforcement have led to otherwise thorough land tenure reform processes failing to deliver anticipated changes (Ikdahl, *et al.* 2005).

If legal reforms are to help poor people strengthen their tenure security, and not weaken it or take away what they already have, it is essential to look beyond full “ownership” of land. This means paying attention to all the bundles of rights, including use, management, exclusion, and alienation rights. Many people have restricted or overlapping and conditional rights to use and manage resources, such as to graze animals or harvest certain products from land officially “owned” by the state or by other people, and these play critical roles in their livelihoods (Wily 2006). Extended family members may have a



certain say over the disposal of land. Simplifying land rights to give complete authority to the owner of the underlying land, ostensibly in the name of efficiency, can cut off other claims important for the livelihoods, social standing, or security of others, with the poor and marginalized groups and individuals often suffering most (Meinzen-Dick and Mwangi 2008).

Unless they take into account the secondary property rights held by various claimants, statutory legal reforms can undermine local land access and use that people depend upon, such as to collect water, firewood, fish or medicinal plants or graze their livestock in the fallow season. Even if their use or management rights were tenuous, their loss can still erode livelihoods, especially for people living on the margins of survival. Yet, many formal systems move toward unfettered “ownership” models, and because of their standardization, they are not as adept at dealing with local variations in secondary claims. Moreover, because land regularization is often a preamble to the development of land markets (Frías 2005; Wily 2006), it is often an explicit intent to shed secondary rights which might be seen as encumbrances that restrict the functioning of land markets. Because these secondary rights are often used for subsistence by the poor, their value is often not counted, and hence overlooked when gains from land market development are cited.

Where government legal systems are more accessible to those with education, money, influence or central location, the poor and marginalized may depend more upon customary or religious bases for claiming rights to resources. This is one reason that many land registration and formalization programmes have led to the erosion of women’s customary land rights, especially in Africa, when land is registered in the name of the male “head of household” (Lastarria-Corhniel 1997). But a study of more recent tenure reforms in Ethiopia found that in regions where land certification procedures required that wives’ names be registered with their husbands’, these requirements increased both women’s awareness of the certification process and the inclusion of women in the registration. These effects seemed to be stronger where the wives’ pictures also had to be included in the certificate (Deininger, *et al.* 2008).

Thus, while the existence of legal pluralism can impede attempts to reform property rights, recognizing legal pluralism and understanding how different systems interact can facilitate pro-poor reforms. No legal framework, whether statutory or customary, is static. “Customary law” evolves in response to changing circumstances, and even without changes in statutory law, its interpretation changes over time. Nor does any legal framework exist in isolation: rather, they influence each other, and changes in one will have effects on the others, leading to changes in property rights in practice.

Rather than seeing legal pluralism as deviations from state law, or as a problem to be eliminated, it is possible to use legal pluralism to effect changes that may benefit the poor or disadvantaged groups. For example, understanding forum shopping can help anticipate responses and design measures for more equitable outcomes. Ethiopia pushed egalitarian provisions in the civil code without trying to undermine customary leaders. First, the government changed the personal law, but allowed those with disputes to lay their cases before the local authorities. However, those who wish to appeal the local decision can choose to apply civil code provisions. As a result, customary personal-law arbitrators and courts in the community have adjusted the application of outdated customary law provisions so that women disputants will be more satisfied with the outcomes and not transfer the decision to the civil courts, which would weaken the customary bodies (Gopal 2001). Thus, changes in state law may be used to effect changes when local elites have power under customary law. But when the wealthy or educated have more access to state-based property rights systems, concentrating power under formal law favours elites, but customary or religious law may exert a countervailing force.

#### IMPLICATIONS FOR STRENGTHENING THE PROPERTY RIGHTS OF THE POOR

Property rights do play a fundamental role, not only in increasing economic productivity, but also in raising the social standing and dignity of those who have them. Strengthening the property rights of poor people can therefore make important contributions to poverty reduction. Not surprisingly, the Commission on Legal Empowerment of the Poor recommended property rights as the second pillar of legal empowerment, after access to justice and the rule of law. This is laudable because it calls for (formalization of) property rights as part of more comprehensive change, including access to justice and building a legal system based on what is working in “extralegal” systems which the poor employ. Access to justice would imply that systems are accessible to the poor, and reduce the concerns that formalization would be misused to take away their property. But if the access to justice does not precede or accompany the formalization of property rights, then the formalization may create opportunities for the elites to capture even stronger claims on resources. Too often, property rights reforms have imported models of formalization not grounded in local realities, or have not provided the financial and human resources to offer decentralized systems that ensure full access by all. The result can make things worse for the poor.

It is now widely recognized that earlier approaches that focused almost exclusively on individual titling may not always be the most appropriate because: (i) title may provide little extra protection for joint and secondary rights (e.g. those of women) that are often of great relevance to the poor and may even weaken or extinguish them; (ii) high survey standards and the centralized nature of a title registration system may increase costs beyond what is affordable to most users; (iii) even if local institutions are deficient, they have evolved over a long time. Attempts to replace them with alternatives may be unsuccessful and, to the extent that they (often inadvertently) undermine traditional institutions without putting in place a viable alternative, may increase the institutional overlap, confusion, and land-related conflict they set out to reduce (Deininger, *et al.* 2008: 1788).

This means that we need to move from viewing statutory law as laying out property rights, to recognizing that this is only one element that shapes tenure security in practice. Statutory reforms can play an instrumental role, but instead of using a single tool for “pro-poor property rights reform”, a broader approach is needed. Legislative changes need to be accompanied by effective implementation, as well as by awareness campaigns, which may use the media, movies, local dramas, or a range of approaches. Civil society and religious leaders can be engaged as well, because customary and religious law are not unchanging. In some cases, redistribution of land from large land holders may also be needed for real poverty reduction (de Janvry, *et al.* 2001).

It would be naïve to attempt any reform of property rights, especially those intended to help the poor, without dealing with power relations. Those who lose out from reforms will resist or subvert the reforms. If those who stand to lose are the powerful, then there will need to be a countervailing force or means of engaging them.

The importance of property rights for poverty reduction comes alongside many challenges that arise in trying to create policies and programmes aimed at promoting tenure security. No universal prescription can apply because tenure regimes need to be adapted to the nature of the resource and the society in which it is to operate. Rural and urban land tenure arrangements are necessarily different; systems appropriate in an irrigated area may not work for rangelands or forests; those suitable for a highly individualized society may not be appropriate where traditions of collective resource management are strong, and vice versa. Security is important, but so is flexibility in many contexts, and property rights reforms need to accommodate differences from one area or type of resource to another.

Instead of looking for clearly defined rules within a single, coherent legal system, it is more useful to recognize the ambiguity of rules, and the multiplicity

of legal systems. This ambiguity and pluralism give scope for human agency, through forum shopping and adapting rules in shaping de facto rights. Allowing people to make such choices is critical for dealing with uncertainties that arise from environmental fluctuations, livelihood changes and other sources.

However, the rules created by local groups are not necessarily more equitable than those made by the state. Even where there are nominal rights, power differences and social relations can prevent people from exercising those rights, which especially affects women or low-status groups. Externally defined laws (from the government or donor projects) can strengthen customary property rights (e.g. by recognizing the resource rights of indigenous peoples) or even provide disadvantaged groups with additional bases for claiming property rights, and thereby increase their bargaining power in negotiations for resources. Such law then becomes a “resource” that can be used by the disadvantaged groups in their struggles over natural resources (von Benda-Beckmann and van der Velde 1992). However, for this to be effective, new laws aimed at strengthening the rights of the poor or other marginal groups must be accompanied by programmes to create awareness by all parties, so that the new laws can be cited and accepted in the negotiation process.

In general, legal pluralism calls for greater humility in policies and programmes. It is not just a matter of getting the “right” law or “right” institution to allocate or manage resources. Instead, rights to resources will be determined through messy, dynamic processes. Yet, this also provides the scope to respond to the ecological, livelihood, knowledge, social and political uncertainties that all resource users face.

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#### NOTE

- 1 This can limit lenders' willingness to accept land as collateral, because they know that it would be difficult to foreclose on a parcel and transfer it to someone else, or that this increases risk and transaction costs.



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# Chapter 9

## How Cash Transfers Promote Work and Economic Security

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GUY STANDING

For decades, policymakers in developing countries and donor agencies, including the international financial agencies, dismissed the idea that poverty could be redressed through cash transfers. They relied largely on social insurance and means-tested social assistance for those affected by particular contingency risks, such as accidents, loss of job, disability or old age, and many showed a remarkable faith in public works. But they gave a very limited role to cash transfers *per se*. Recently that has changed.

One reason is that the aggravation of poverty and inequality under globalization defied the prediction that economic growth would “trickle down” to the poor and economically insecure. Another is that other forms of aid have had limited effect, especially in the context of systemic shocks, involving mass entitlement failures in which whole communities are blighted by an economic setback, ecological disaster or epidemic.

This chapter first presents principles for assessing the effectiveness of various types of income-support scheme in combating economic insecurity. Using those principles, it goes on to review experiences with food aid and vouchers, seen as the main alternatives to cash transfers, before discussing the growing use of conditional cash transfers. Separate sections deal with cash transfers in emergency and development aid, incomes for school attendance, social pensions and disability grants. It concludes that experience with cash transfers supports moving to universal unconditional cash transfers.

### ECONOMIC INSECURITY AND SOCIAL JUSTICE PRINCIPLES

Briefly, economic insecurity reflects *exposure* to several forms of risk and uncertainty, limited capacity to *cope* with adverse outcomes, and limited ability to *recover* from them. To a greater or lesser extent, everybody is exposed to idiosyncratic risks, reflecting life-cycle contingencies, such as a spell of



unemployment, illness or a disabling accident. This is the sphere of classic social security. But there is also co-variant risk, where one adverse event has a high probability of triggering others, and systemic risk, where whole communities are exposed.

This leads to the distinction between *shocks* and *hazards*. Shocks have become more numerous as a result of globalization and global warming. Included are sharp economic downturns, and what one can characterize as socio-economic disasters, whether they be quick-onset shocks, as in the case of earthquakes, floods, tsunamis or a sudden economic collapse, or slow-onset shocks, as in the case of droughts, famines or an epidemic such as HIV/AIDS.

Hazards are also important sources of economic insecurity in developing countries, and may be defined as predictable life events that have a high probability of an adverse economic effect for an individual or family. They include a death of a relative, weddings, births, a migration event and retirement. The resultant costs can erode a household's capacity to sustain its normal livelihood base, perhaps by pushing it into debt or into mortgaging land, or by preventing it from buying seeds or fertilizers. Hazards have always existed, but with commercialization and rising financial costs of basic services, their threat for low-income families has intensified.

Economic insecurity also arises from uncertainty ("unknown unknowns"). With uncertainty, one is unsure about one's actual interests and how to realize them. The outcome of decisions cannot be predicted with confidence, and often this is combined with lack of knowledge about what to do if an adverse outcome materializes. Chronic uncertainty pushes people into more risk-averse behaviour, especially if the consequences of an adverse outcome could be catastrophic. This is particularly likely in agrarian economies or where production is dependent on climate. Anything that lessens the uncertainty can be expected to have a beneficial effect on higher-yielding investment, innovation and purposive decision making.

So, security arises from being able to deal with risks, shocks, hazards and uncertainty. It is a premise of this chapter that basic economic security is essential for freedom and development. Basic economic security is defined as a threefold set of circumstances—limited *exposure* to idiosyncratic, co-variant and systemic risks, uncertainty, hazards and shocks, an ability to *cope* if they materialize, and an ability to *recover* from adverse outcomes if they arise.

### *Types of Income Support Scheme*

Schemes that might promote economic security, and poverty alleviation, can be defined by their intended *coverage*. We may say that a scheme is

*universalistic* if the benefit is intended as a right for all the population, perhaps based on citizenship or long-term residence. A scheme is *targeted* if it is intended for “the poor”, defined by some test of eligibility, such as a means test. A scheme is *selective* if it identifies a particular group, such as women with children, as the intended recipients. A scheme is *conditional* if it requires specified behaviour, usually work related, on the part of the recipient or in, some cases, the recipient’s family members.

In practice, there are instances of universalistic selective schemes for which all those belonging to some group are eligible regardless of means. An example is the social pension introduced in countries such as Namibia and Mauritius. More common are targeted selective schemes, which define intended beneficiaries by their status (e.g., women with children) and by their poverty (having income or assets below some threshold value).

Means testing has been criticized as inequitable and a deterrent to work, especially for low-skilled workers, through “poverty traps” and “unemployment traps”. The problems are compounded by the difficulty of applying meaningful tests to incomes that fluctuate erratically and substantially. Starting in Chile in 1980, this has prompted many countries to resort to proxy means testing, where visible indicators of income are used to determine eligibility for benefits (Clert and Woden, 2001; Raczynski, 1991). This obviously requires selection of relevant indicators of deprivation, such as location of residence, quality of dwelling or type of economic activity the household is engaged in. None of these is a very reliable indicator of poverty. Accordingly, some authorities have been drawn to rely on sophisticated statistical models, using a few variables to estimate the profile of somebody who should be regarded as in need. However, the technique is prone to four types of failure that should be used to assess any social protection scheme.

Schemes can have a *high exclusion error*—that is, exclude a large number of those for whom the benefit is supposedly intended. This is particularly likely with area-based targeting. Schemes may also have a *high inclusion error*—that is, include people for whom the benefit is not intended. Third, schemes may have a *high administrative cost* relative to the cost of the overall scheme, often meaning that far fewer people can be beneficiaries, given limited resources. Fourth, schemes may have a *high transaction cost* for the intended recipients, in that they have to do a lot in order to obtain the benefit.

In the case of proxy means tests, collecting and analyzing data to be used in a formula to identify the targeted group will involve hefty costs. There will also be substantial exclusion errors, since even the best econometric equations estimate only about 50 per cent of the variability of income, implying an imperfect means of identifying potential recipients (Coady, Grosh and Hoddinott,

2004). Such schemes also involve “immoral” hazards if the proxy indicators are known, since possible recipients may go without in order to qualify. In short, proxy means tests are little better than the means tests they replace.

### *Policy Evaluation Principles*

This chapter is based on a belief that policies should be evaluated by whether or not they satisfy the following five policy principles:<sup>1</sup>

*The Security Difference Principle—A policy or institutional change is socially just only if it improves the security of the least secure groups in society.*

The Security Difference Principle stems from Rawls, who from a liberal philosophical perspective argued that social and economic inequalities are only just if they allow for the betterment of the worst-off groups in society (Rawls, 1973).

*The Paternalism Test Principle—A policy or institutional change is socially just only if it does not impose controls on some groups that are not imposed on the most free groups in society.*

Underlying this is the Millian liberal view that there is a prima facie case against paternalism (except in the case of young children and the medically frail), particularly against those forms that constrain the freedoms of the disadvantaged.

*The Rights-Not-Charity Principle—A policy or institutional change is socially just if it enhances the rights of the recipient of benefits or services and limits the discretionary power of the providers.*

A right is possessed by virtue of a person’s humanity or citizenship, and surely cannot be made dependent on some behavioural conditionality. Social and economic entitlements should be rights, not matters for the discretionary decisions of bureaucrats or philanthropists or aid donors.

*The Ecological Constraint Principle—A policy or institutional change is socially just only if it does not involve an ecological cost borne by the community or by those directly affected.*

This is the quintessential 21st century principle. Benefit schemes should be subject to the constraint that they should not deliberately or carelessly jeopardize the environment.

*The Dignified Work Principle—A policy or institutional change is just only if it does not impede people from pursuing work in a dignified way and if it does not disadvantage the most insecure groups in that respect.*

The two-part test here involves two value judgments—that work that is dignifying is worth promoting (whereas deterioration in working conditions or in opportunities would not be), and that the policy should enhance the range and quality of work options of the most insecure groups relative to others, or more than for others. The main point is to determine if a scheme favours the development of more freely chosen work opportunities and work capabilities.

Finally, it is also worth recalling Tony Atkinson's two measures of poverty-reduction efficiency—*vertical*, measuring the extent to which there is leakage of money intended for the poor going to the non-poor, and *horizontal*, measuring the extent to which the poor are actually helped (Atkinson, 1995). A difficulty with this dualism is that, for example, a scheme may reach 70 per cent of a target group, but they may be the least severely affected, leaving the worst-off 30 per cent no better off. And, for instance, if another programme reached 70 per cent who were the worst-off and did so at the cost of some leakage to the non-poor, that might be judged less efficient. It is thus advisable to be cautious about evaluating policies using the language of efficiency.

The following considers the main alternatives to direct cash transfers and then turns to a more detailed discussion of conditional and universal forms of transfers. It leaves out of consideration cash-for-work and emergency public works schemes, which have been written about elsewhere, using the same criteria (United Nations, 2007: Chapter VI).

## NON-CASH TRANSFERS

### *Food Aid*

The claim in favour of food aid, including subsidized food, is that it is an anti-poverty device that responds to the priority needs of the poor. It is also perceived as horizontally efficient in that it is *self-selecting*. The poor will want the food aid; the wealthier will not. Food aid, it is reasoned, will also be appreciated by recipients, as well as easy to legitimize with donors and the median voter.

The main criticism is that the vulnerable may not lack food *per se*, or may not see their future as made secure by access to more food. Such commodity-based aid is also paternalistic, in that it presumes that what people want is more food, and/or that they would not spend money on food if given the freedom to make choices for themselves.

Food aid is also potentially market distorting, eroding incentives for local farmers, especially if the food is coming from outside the community. It can thus disrupt local livelihoods and employment. Even the prospect of an influx of food aid can be a deterrent to local farmers or market traders. It may thus fail the Dignified Work Principle.

Food aid also engenders a sense of charity rather than economic rights. As with all subsidies, subsidized food will be less appreciated than if the market price were paid. Food aid will therefore tend to result in more waste, due to undervaluation, and/or excessive consumption just because it is “free” (Tabor, 2002). Distributing food aid also has high transaction and administrative costs. For instance, in India, the widely used meals-for-school scheme is notorious—each rupee of food costs a rupee to distribute.

Finally, food aid often leads to perverse targeting, reaching those without much need for food while not reaching those who desperately need it, who may be more inaccessible.<sup>2</sup> Thus it may, perversely, fail to satisfy the Security Difference Principle as well.

Though food aid is rightly the classic form of aid in times of emergency, there is growing recognition that to be effective, it must usually be combined with cash grants if the intervention is to prevent the collapse of livelihood capacity in the affected communities. There is now considerable evidence from food-aid schemes that, without monetary assistance, many recipients have to sell their food aid or cannot retain their land or raw materials because of accumulating debt. This was found to be the case, for instance, with food aid to refugees in Chad (LeJeune, 2004) and with emergency food hand-outs in the Great Lakes region of Africa (Levine and Chastre, 2004).

In occupied Afghanistan, beneficiaries of food aid were found to be selling the food they had received for less than a third of the cost of its delivery (Development Researchers Network, 2003). And an evaluation of food aid in Ethiopia concluded that households would have taken much less in cash than the market value of their food aid and been equally satisfied (Barrett and Clay, 2003; see also Barrett, Holden and Clay, 2002). In sum, food aid does not do well in terms of the five policy principles.

*Vouchers and Food Stamps*

Vouchers are in fashion. The most common have been for seeds and other agricultural inputs, the intention being to boost output and employment while curbing food poverty. Vouchers have also been used in foreign aid to communities hit by economic or natural disasters, as in the aftermath of the tsunami, in Indonesia, Sri Lanka and elsewhere, in the occupied Palestinian territories, and in the UK government's response to the Montserrat volcanic eruption. Significantly, in the last case, the authorities eventually switched to cash grants after recipients complained that the vouchers were too restrictive.

Among the claims in favour of vouchers is that they are, or could be made, self-selecting of those in need, if the items that can be obtained with vouchers are what the wealthy have in abundance or do not want. Some have even argued that there should be stigma attached to receipt of vouchers precisely to increase the self-selection.<sup>3</sup>

One criticism of vouchers is that they require considerable planning and preparation, including the agreement of local traders to accept the vouchers. There have been reports that shops do not like dealing with vouchers because they involve extra administrative costs and uncertainty about reimbursement. Another criticism is that, contrary to the claim that they promote self-selection, the stigmatization entailed by vouchers leads to lower take-up, not higher. Applying for and using a voucher are visible transactions that signal poverty or dependency, and there is no reason to presume this will result in self-selection by the poorest and most insecure. In the UK, the Government had to abandon a special voucher scheme for asylum seekers precisely because recipients were being identified and harassed.

By definition, vouchers are paternalistic, in that they involve a decision by the state (or donor) on what they think people should be spending money. However well-meaning, that is a restriction of individual liberty. This is perhaps why the best form has been "seed vouchers" combined with "seed fairs", in which the paternalistic element has been moderated by enabling recipients to choose from among a range of seeds. Such fairs have worked well in parts of Africa.

Any subsidy distorts spending patterns. Extensive research has shown that the US food stamps programme has resulted in people buying more food than they would have, had they received the equivalent in cash. Given the high incidence of obesity among the US poor, that in itself would be a reason to convert the voucher into a cash transfer. Giving cash would not ensure it was spent on healthier food, but there would be a lower probability that it would be spent on excessive food. How it would be spent would be a matter of personal freedom.

## CASH TRANSFERS

There is a growing movement in favour of cash transfers and even universal income grants in countries where it is commonly claimed that no universal system of social protection is financially feasible. Surveying the literature, a senior World Bank economist put it thus:

*The conventional wisdom ... is that income transfers to the poor, and safety net policies more generally, are at best a short term palliative and at worst a waste of money. These views are starting to be questioned at two levels. Firstly, evidence from careful evaluations has pointed to a number of success stories. ... Secondly, the presumption of an overall trade-off between redistribution or insurance (on the one hand) and growth (on the other) has come to be questioned (Ravallion, 2003).*

### *Cash Transfers in Emergency and Development Aid*

The advantages of cash transfers in emergencies include speed, transparency and the ability to allow those in need to make choices about how they spend the aid, thereby enabling them to retain a greater sense of dignity in times of crisis (Creti and Jaspars, 2006).

Based on experience in Africa, Asia and Latin America, Oxfam has issued guidelines for such schemes, recognizing that they are particularly appropriate for crises where local purchasing power has been wiped out while food and other basic goods are potentially available. They also have low administrative costs. As a World Bank study on Colombia's experience concluded:

*The cost of SISBEN design and application has been modest in absolute terms (about US\$0.21 per person in the registry, US\$0.52 per beneficiary), and relative to the total amount of resources that have been targeted with SISBEN. It has been estimated that to target US\$100 dollars to a beneficiary costs less than US\$70 cents. For some programs, such as the Conditional Cash Transfer (CCT-Familias en Acción), the cost of SISBEN is about 0.5 per cent of the total cost of the program (assuming this is the only program using SISBEN) (Castañeda, 2003).*

One scheme that has been carefully evaluated is the Cash for Relief Programme (CfR) in Ethiopia. An objective was to enable households hit by crop failure to rebuild their assets. The evaluation found that the grants had been very successful in regenerating livelihoods (Brandsetter, 2004). Rather than merely consume (which would have been likely with food aid alone), the

recipients had controlled debts and invested in restoring land productivity. The donors found that cash grants “allowed individuals and communities to begin making a series of decisions, giving them the power to prioritize needs for their families and presenting them with a creative way to receive relief assistance with dignity” (USAID, 2004).

An evaluation of the Meket Livelihood Development Pilot Project, involving cash transfers provided in two areas of Ethiopia in 2001–2004, found that the cost of implementing the scheme was much less than the equivalent for food aid (Kebede, 2005). The latter also had substantial transaction costs for beneficiaries (rarely taken into account in evaluations), including time spent waiting for deliveries and sharing out food as well as the work involved in loading and transporting the aid.

By contrast, cash transfers allowed beneficiaries to make strategic choices for themselves. The evaluation found that the transfers allowed households to build up assets, notably through acquisition of livestock, enabled some to reduce distress renting out of land, and enabled recipients to obtain higher crop prices, partly because they were able to sell when prices were favourable, rather than when they were desperate for cash. These are classic advantages of having basic economic security. They also helped some to pay off debts, others to pool savings in an *equb* (group saving scheme), and others to buy seeds, sheep or goats, thereby enabling them to work.

Evaluations of other cash relief projects in Ethiopia implemented by Save the Children in response to food crises concluded that they too functioned efficiently, proved more cost-effective than food aid, and had no inflationary effect (Gebre-Selassie and Beshah, 2003; Save the Children UK, 2004; Knox-Peebles, 2001). Successful schemes have also been implemented in northeastern Somalia (the Emergency Cash Relief Program), and in two districts of Zambia (the Kalomo Social Cash Transfer Scheme) initiated by the Government with financial support from the German development agency, GTZ.

In the Zambian scheme, which focused on very poor households with little access to paid work, it seems the money was spent mainly on basic consumption goods and education and healthcare for family members (Schubert, 2005). In other words, people spent the cash rationally for their own longer-term welfare. A majority of the beneficiary households were headed by elderly persons or women, about half were AIDS-affected, and nearly half contained orphans.

The Zambian scheme had a more general message. It was estimated that if it were scaled up to reach the poorest 10 per cent of all Zambian households, the cost would amount to merely 5 per cent of all overseas aid to the country, or about 0.5 per cent of its GNP. So, a national scheme was financially feasible.



It would be much cheaper than the country's food aid, and have the advantage of going directly to the poor and vulnerable, without the high administrative costs and corruption associated with commodity-based schemes. And whereas food aid damages local markets by deterring local producers, cash transfers would do the opposite by stimulating markets. In Zambia, no less than 70 per cent of all social transfers are spent on locally produced goods and services, thus generating local livelihoods (DFID, 2005; Samson, van Niekerk and MacQuene, 2006).

The Zambian, Ethiopian and Somalian experiences offer encouraging evidence that cash transfers are affordable and conducive to livelihood revival in chronically poor areas. Of course, in emergencies, cash grants should not be seen as pure alternatives to forms of commodity-based aid. Such transfers might be inflationary if food supplies were unavailable. In the aftermath of a disaster, food aid may need to complement cash transfers, to restrain inflationary pressures. Commodity aid can then be gradually phased out as local producers respond to the increased demand for staple goods and services. However, cash transfers may need complementary programmes designed to boost local supply, as was the case following the Mozambique floods in 2000.

Among the growing number of schemes launched outside Africa as part of emergency and rehabilitation programmes is the Cash for Herder scheme in Mongolia, implemented by the Swiss Agency for Development and Cooperation (SDC) and the Red Cross in 2002–2003. The evaluation two years later found that while an in-kind project was “appreciated” by recipients, it had not helped regenerate the economy, whereas the cash transfer had led to investment in assets that regenerated livelihoods. It concluded:

*The cash approach made use of the creativity and experience of beneficiary families to develop strategies out of their crisis ... [It] showed that poor people and people under severe economic stress are very well capable to handle cash responsibly and develop and take strategic decisions on what to spend the money in order to improve the livelihood and their families in the medium and long term ... most important, beneficiaries do become economic and social actors in their own community again (SDC-IFRC, 2005).*

The evaluation also found that “the response and preparation time” was short and administrative overheads were low. Encouraged, by 2005, the SDC had implemented 13 cash grant projects of this type in eight countries.

The growing legitimacy of cash transfers was also reflected in the Group of Eight Statement of 2004, which, when referring to the international response to famines, made the commitment, “we will unleash the power of markets

through cash-for-work and cash-for-relief programs” (G8 Statement, 2004). The scope for cash transfers in Africa and Asia is thus recognized as part of the armoury of aid and humanitarian responses to poverty and insecurity. Meanwhile, in Latin America, cash transfers have become central to social and development policy.

## CONDITIONAL CASH TRANSFERS

So-called conditional cash transfers (CCTs) are in vogue, although the distinction between conditional and unconditional is not as sharp as is sometimes depicted. One reason is that some policymakers use conditionality as a device to legitimize the transfer with middle-class voters and financial agencies, as was the case in the early *Bolsa Escola* schemes in Brazil. In practice too, the difficulty and costs of implementing the criteria used for identifying beneficiaries can lead to token or discretionary application of the conditions. This has been the case of the state old-age pension in South Africa, which has been a success in redistributing income and boosting small-scale economic activities.

Nevertheless, what commentators usually have in mind when discussing CCTs is a combination of targeting, selectivity and conditionality. This erects a system of social engineering that multiplies moral judgments and the scope for unfairness, especially as little heed is paid to effects on the excluded or to the longer term.

The most well-known condition is that recipients should send their children to school. This is a form of paternalism, but it is a modest one, given that society usually has a constitutional commitment to ensure children are enrolled in and attend school. Other forms of conditionality are harder to rationalize on ethical or freedom-enhancement grounds.

It is our contention that the growing interest in CCTs as an aid and development tool will lead to a realization that most forms of selectivity and conditionality are costly, inequitable, inefficient and offensive to egalitarian principles. Nevertheless, the current phase of policy development is promising because experimentation with conditional transfers is proving that they can have a beneficial development role. We consider unconditional, universal income transfers later.

### *CCTs: Income Conditional on School Attendance*

This form of conditional cash transfer has become enormously popular. The main claim is that incomes conditional on school attendance lower the poverty and

economic insecurity of women and children, breaking the inter-generational transfer of poverty, through “human capital” formation. It is claimed that they reduce child malnutrition, and promote school enrolment and attendance. Such schemes are less paternalistic than food parcels and food aid, or other commodity-based forms of transfer. They are also a means of redistributing income that is relatively easily legitimized among the middle class and “median voters”.

Critics argue that, by focusing only on school-age children, these schemes neglect families with children under the age of seven, the group most at risk of ill-health due to malnutrition and impoverishment. There are also claims that they discourage female labour force participation and that they involve high administrative costs, particularly as they are means-tested.

Despite these criticisms, country after country has opted for this policy. Latin America has led the way, starting in Mexico, where the *Progresa* (literally “progressing”) scheme, introduced in 1992, has evolved into the *Oportunidades* scheme.<sup>4</sup> *Progresa* was supposed to support poor school-age children in marginalized rural communities, but in 2002, *Oportunidades* extended that to other rural and urban areas, reaching about 3 million Mexican households at any one time.

Although awkward questions remain about the efficiency and equity of the selectivity process, *Progresa/Oportunidades* has been less expensive to distribute than food aid (Gertler, 2005) and has reduced poverty, increased school enrolment and attendance, and improved health (Skoufias, 2001). In short, the scheme has become a central part of the country’s social protection system.

Another major example is the *Bolsa Familia* (“family stipend”), the flagship of Brazil’s cash transfer schemes, which contributed to President Lula’s re-election in 2006.<sup>5</sup> A central part of the Government’s *Zero Fome* (“Zero Hunger”) campaign, it has helped reduce the country’s enormous income inequality. It also unified a variety of paternalistic and selective schemes, such as the gas allowance and school stipends. An intention has been to break the inter-generational transfer of poverty by conditioning access to transfers on human development objectives (schooling, nutrition and health). It is also seen as a means of “empowering” women, giving them more bargaining power and enabling them to make decisions on their children’s education and on their own work.

By 2008, the *Bolsa Familia* reached over 12 million households living below the official poverty line, or over 46 million people. The scheme is nominally means-tested, with the amount determined by number of children. Autonomy is granted in that recipients can choose how to spend the money, but the conditionalities (“incentives”) are restraining, and include school attendance by

children aged 5–15, antenatal classes for pregnant women, and vaccination for children under the age of 7. The scheme is nevertheless evolving towards being more universal and less conditional.

The *Bolsa Familia* has generated enormous global interest. There have been a series of evaluations and monitoring projects, mostly favourable (Britto, 2005; Fonseca, 2006, *inter alia*). The consensus is that the transfers have reduced female poverty, increased school attendance and school performance, and increased female labour force participation. Indeed, one study of the earlier scheme concluded, “instead of the expected negative correlation between *Bolsa Escola* and work, we find the opposite: those receiving the stipend are the ones that work more” (Schwartzman, 2005).

The effect on child labour is less clear, since cash transfers seem to have resulted in children doing fewer hours of labour, but not necessarily stopping altogether (Cardoso and Souza, 2003; Rocha, 2000). This is partly because prohibiting child labour is not part of the programme. Child labour has continued to play a role in the survival of poor households, accounting for 20 per cent of family income in about a third of all families. The stipend is too modest to displace that.

Other similar CCTs are Colombia’s *Familias en Acción*, Honduras’ *Programa de Asignación Familiar* (PRAF), Jamaica’s Programme of Advancement through Health and Education (PATH) and Nicaragua’s *Red de Protección Social* (RPS), which predated the Brazilian model. There is also growing interest outside Latin America, a beacon being Bangladesh’s Cash for Education scheme. By 2008, the Indian Government was considering the *Bolsa Familia* as an alternative to its wasteful food subsidies.

To what extent does this type of scheme satisfy the Principles enunciated earlier? Undoubtedly, the policy is paternalistic. Many observers would accept it as desirable to impose conditions that benefit children, and would be satisfied as long as the scheme did not put families into a poverty trap. However, the Mexican scheme goes much further, raising questions about excessive bureaucratic intervention in family life of an intrusive kind that could lead to stigma and even non-application for the benefit. To the extent that there is a political commitment to weaken the conditionality, Brazil’s less intrusive *Bolsa Familia* scores better on the Paternalism Test.

As for the Security Difference Principle, the complexity of Mexico’s targeting procedure raises questions about horizontal efficiency and omission of many of the poorest. There could also be a poverty trap if households lose entitlement to the benefit if they move out of poverty, thus discouraging work and social mobility.

As far as targeting is concerned, research suggests *Progresa* was effective in reaching very poor households in very poor areas, but was less effective in reaching the “moderately poor” (Skoufias, 2001: 43). To that extent, it could be said to have satisfied the Security Difference Principle in being horizontally efficient. But in all these schemes, excluded from coverage are households with only pre-school age children or without any children, as well as orphans and others living outside households altogether. It cannot be claimed that the targeting reaches the most impoverished.

Moreover, in both Nicaragua and Mexico, about 20 per cent of the cash beneficiaries were non-poor (Coady, Grosh and Hoddinott, 2004). In Bangladesh, where targeting has been weaker, about 40 per cent of beneficiaries have been non-poor. As targeting is supposed to exclude the non-poor, this suggests that the schemes have not been very successful on their own criterion.

These schemes also depend on a sophisticated up-to-date registration system. Unregistered households cannot obtain benefits, which is why many poor and insecure families do not obtain them. And the economically insecure tend to have incomes that fluctuate above and below any poverty line, making it a bit of a lottery whether or not they manage to qualify.

To succeed in its broader aims, this type of scheme also depends on there being adequate local schooling and health and transport infrastructure. In urban areas of Latin America, these may exist. But in rural areas of those countries, and in much of Africa and Asia, the imposition of school-attendance and clinic-attendance conditions may impose onerous burdens on poor households, and hit the very poor more than anybody else.

Even in Latin America, the desirability of the conditionality has been questioned, prompting a growing number of policymakers to conclude that less conditionality would be more efficient and equitable. The complexity of requiring people to prove they are poor and vulnerable, and to demonstrate regular attendance at schools and clinics (or to prove they had a valid reason for not doing so) is surely off-putting for people cowed by poverty and chronic insecurity. It is also expensive in administrative time and paperwork (Ayala Consulting, 2003).

The biggest question is one at the heart of all debates on social protection in the 21st century. Are the conditions necessary if they simply require people to do what is in their best interest? Obliging a mother to send a child to school might seem obviously beneficial, but pressure to do so—and fear of income loss if she does not—may lead to the perverse outcome of a mother sending a sick child to school, to the longer-term detriment of the child and family. One can think of many other circumstances that should cause disquiet.

The imposition of conditions presumes that a poor person is irrational or incapable of learning, does not know his or her long-term interests, lacks information or cannot act in the child's longer-term interest because of some impediment. Dealing with those issues directly would be more effective than imposing conditions that eat up resources in administering them, while perhaps ignoring structural factors that impede seemingly rational behaviour. Even in the case of children, one cannot accept state paternalism uncritically.

This concern is one that may preoccupy the second-generation reformers as assessments of income-for-school-attendance schemes unfold. What is clear is that they are compatible with more independent economic activity. The Dignified Work Principle is supported by the fact that women's labour force participation has been boosted by such schemes, contrary to claims that cash transfers foster dependency.

#### TARGETED, SELECTIVE CASH TRANSFERS: DISABILITY GRANTS

Here, we will deal with a variant of disability grants, as introduced in southern Africa, in Mauritius, Mozambique, Namibia and South Africa. They are both means-tested and work-tested, and are proving disastrous.

Under the South African scheme, a *permanent* grant is supposed to be available to anyone with a disability expected to last for more than a year; a *temporary* grant is supposed to be given to anyone with a recognized disability expected to last between six and twelve months. If a person deemed disabled is below the age of 18, they can obtain a care dependency grant instead. Access to the grant is based on a complex procedure, based on an assets value test, an earned income test and a joint assets test, since for married couples the joint assets must be less than a designated amount. But the conditionality does not stop there, because the scheme also requires applicants to demonstrate a medical condition and incapacity to work. It is this cocktail of tests that is a recipe for social disaster.

In Namibia, a disability grant modelled on the South African scheme has been growing in significance in the context of the HIV/AIDS pandemic. The grant has become Namibia's second most prevalent income support mechanism, part of an evolving system of selective, targeted transfers that includes three family benefits—the foster parent grant, the child maintenance grant and the orphan's grant. Only a few households have received any of these means-tested benefits, which involve poverty traps and the moral hazards that come with all means-tested schemes.

It is thus not surprising that the disability grant reaches no more than about 20 per cent of all those who should be reached, according to Namibian census figures for the number of people suffering from chronic impairments (Standing, 2006). It is moot whether it reaches many AIDS victims who become disabled as the sickness intensifies. If it does not reach them, the danger is that anti-retroviral (ARV) treatment will fail since unless a person can eat reasonably well, the medication will not work. However, if it were to reach a large proportion of AIDS victims, the fiscal cost would be large.

The primary problem, however, is the conditionality. To be entitled, a person must obtain a doctor's certificate stating that he/she is not only disabled, but also unable to do income-earning activity. The rule has been that those with a CD4 count—a measurement of the body's immunity—below 200 are entitled to a temporary disability grant, if they pass those means tests. They are supposed to de-register if their CD4 count improves to above 200 due to anti-retrovirals. Because of this, coupled with the nature of the ARV rollout, a bizarre sickness poverty trap has been created.

In areas where the ARV rollout is operating, if an AIDS victim is sufficiently sick, he/she qualifies for treatment. Most recipients are wretchedly poor. So, two tendencies have emerged. Some of those receiving ARVs have been sharing their pills with relatives and friends who are not quite sick enough to qualify. Taking half the dose does not slow down the rate of recovery from the disease; it makes the treatment ineffectual and may build up drug resistance. Other ARV recipients have gone one stage further—they have been selling the pills. In Namibia, some have been selling them over the border in Angola. The short-term need for food to survive overrides the need for health to survive in the longer term. Thus, the ARV rollout will fail because it is not linked to income security.

Second, the work capacity test for eligibility for the grant creates a unique moral hazard. If the ARV treatment improves the patient's condition, so the capacity to work improves. And if it does, the patient loses entitlement to the benefit. In Namibia and South Africa, there are credible reports that people have stopped ARV treatment in order to push themselves back below the capacity-for-work level, for fear of losing the grant.<sup>6</sup> According to the South African Treatment Action Campaign, which has been advocating a universal basic income instead, there have been many instances in which patients have simply refused treatment for fear of losing their disability grant.

Furthermore, there are fears that the yo-yo effect—in which sick individuals take treatment for a while, see their health improve slightly, stop treatment until it worsens, start again, stop again, and so on—is fostering the development of treatment-resistant strains of the disease.

Thus, the disability grant must rank as one of the worst designed cash transfer schemes in the world. It does not satisfy any of the Policy Principles. It is a classic case of how a combination of means testing and work-capacity testing can achieve the opposite of what policymakers intend. Surely, enough is known to scrap the work test and the means test in disability grants.

By contrast, in the early 1990s, following Mozambique's civil war, the Government introduced a simple unconditional cash transfer scheme for those disabled or displaced known as GAPVU, or "cash payments to war-displaced urban destitute households programme". This reached about 16 per cent of urban households and raised average incomes by as much as 40 per cent, significantly reducing poverty (Devereux, Marshall, MacAskill and Pelham, 2005; DFID, 2005; Samson, van Niekerk and MacQuene, 2006). It also boosted small-scale employment and the livelihoods of the urban poor, notably raising food production and trading activity. The scheme had a means test, but the authorities largely ignored it, contributing to the programme's success. It is a lesson for those wedded to selective, targeted alternatives.

#### UNIVERSALISTIC UNCONDITIONAL CASH TRANSFERS: SOCIAL PENSIONS

With global ageing and with the dislocation of families pushing more elderly out of family-based support networks, support for social pensions has grown. Many countries have some means-tested state pension, but more interesting is the non-means-tested variety, that is, a basic universal state pension provided to all above a certain age without conditions, such as a record of contributions, being required for entitlement (Palacios and Sluchynsky, 2006). It is sometimes depicted as a primary pillar of a multi-pillar pension system. The interest arises, not just because it offers the prospect of cutting old-age poverty dramatically, but because it may also be a productive investment, directly and indirectly boosting dignified livelihoods.

It is ironic that social pensions have been pioneered in a few developing countries where poverty and inequality are rife and where many economists would say there are no resources available to pay for them. Variants exist in South Africa, Namibia, Nepal and Mauritius, where the amount paid rises with age, and Botswana, Bolivia, Samoa, rural areas of Brazil and Lesotho, which introduced it in 2004 for those over the age of 70. The Indian NOAPS (National Old Age Pension Scheme) is tending towards being a social pension as well, albeit giving a tiny amount and with notorious inefficiency. Chile has also introduced such a scheme. In addition, by 2007, over 30 developing and



transition countries were operating means-tested, non-contributory pensions (Johnson and Williamson, 2006).

Besides enhancing old-age income security, social pensions have influenced patterns of work and labour. The primary claim in favour of the non-means-tested variant is that it is universal and rights-based—all elderly citizens are entitled to receive a monthly amount. Social pensions reduce old-age poverty better than any alternative, are redistributive, affordable and transparent, and have very low administrative costs. They typically account for a tiny percentage of GDP; in Costa Rica, for example, they took only 0.3 per cent in 1999, and in Zimbabwe, only 0.1 per cent (Coady, Grosh and Hoddinott, 2004; Munro, 2003). Another strong finding is that the South African pension was the only successful redistributive policy in the post-apartheid era (Case and Deaton, 1998).

It is still often claimed that social pensions are costly because they are universal. But it is because they are universal that they reach nearly all the elderly, and do so remarkably cheaply. Perhaps Namibia has the most efficient social pension, operated via an electronic card and biometric identification. Each month, vans go to the villages and urban payment spots, each van containing cash-dispensing machines and computers. The pensioners (or designated surrogates if they are too ill or frail) present their cards at the van and are paid the equivalent of US\$30. The take-up rate is about 90 per cent, which is high by comparison with all other pension schemes in developing countries, and is higher than any means-tested scheme operating anywhere.

The Namibian scheme is administered by a company on contract to the Government. The monthly costs are equivalent to about 30 US cents per person, also remarkably low by comparison with other systems. To prevent fraudulent claims on behalf of dead people, the authorities ingeniously introduced burial insurance; the pensioner, on registering for the pension, takes out a mandatory life insurance, whereby funeral costs are covered when he or she dies; application for burial funds enables the authorities to cancel the card. Given the cultural significance of decent burials and their cost, the insurance scheme has been found to be successful in all respects.

Also remarkable is the effect on livelihoods. Social pensions have helped preserve family structures, enabled grandparents to pay for the schooling of grandchildren, paid for the care of family members suffering from HIV/AIDS, made the elderly creditworthy and promoted sustainable livelihoods, particularly in rural areas.

Social pensions are productive. A neglected lesson from European history is that increased old-age security acted as a powerful force in modernizing agriculture, because it led to more risk-taking innovation. It has done so in

rural Brazil. As one study concluded, “the regularity, certainty and liquidity of pension benefits meant that they played a key role in shifting households from subsistence to surplus agriculture” (Barrientos and Lloyd-Sherlock, 2002: 17; Barrientos, Lloyd-Sherlock, Ferreira, Moller and Saboia, 2003).

Besides its consistency with the Dignified Work Principle, the social pension satisfies the Security Difference Principle if it is not means-tested. Being universalistic, it should reach all the elderly poor. It is also paid to individuals, rather than households, thus satisfying a universalistic concern. It is non-paternalistic, allowing the beneficiary to spend on what he or she chooses; and it is granted as a right rather than a discretionary matter of charity. In brief, it is a feasible first step in the direction of a universal right to income security.

The debate on whether a basic state pension should be universalistic or means-tested rumbles on, but the signs are that the universalistic variant is gaining ground. South Africa is just one country in which pressure has been growing to end the residual use of means testing in its social pension. There and elsewhere in Africa, the IMF and other financial agencies have been trying to move governments in the other direction. But the evidence that this would be sensible in terms of equity or efficiency is simply not there.

## CONCLUDING REMARKS

As the global market society takes shape in the aftermath of globalization, the policies and institutions that emerge will tend to reflect common challenges—a prevalence of unstable jobs, fragmented family structures, a changed nature of risk exposure and so on. Thus far, industrialized countries have responded to globalization’s challenge to the traditional social insurance model with increased reliance on means testing and behaviour testing, coupled with social therapy and coercion. Yet, there is a counter-movement led by what is happening in developing countries, where the baggage of 20th century social security is light. The industrial labour model does not apply; most people are outside “formal” wage labour, and the main risks to which most people are exposed do not correspond to the contingency risks that underpinned welfare states.

In particular, communities and individuals are more exposed to systemic or co-variant risk. Distinctions between the deserving and the undeserving are arbitrary in contexts where ill-luck and chronic uncertainty are undeniable realities. Emergencies, shocks, crises—all force those involved in shaping policy and reacting to events to abandon old prejudices.

Ultimately, this means not just having food or other commodity hand-outs, but being able to develop sustainable livelihoods in viable communities based on functioning systems of social solidarity. That lesson is being re-learned, posing awkward questions to those wedded to selectivity, targeting and conditionality.

A claim in favour of unconditional cash transfers is that, being universal, they are socially just. They are non-labourist, in that they do not presume that some forms of work are deserving of support and others not. By making all forms of work equally deserving, they promote work by allowing people to make choices between types of work more easily. For that reason, among others, universal cash transfers favour women relative to other forms of social security because each individual receives an individual transfer and because those doing non-wage work, such as childcare or eldercare, are not penalized.

Because a universal, unconditional cash transfer is granted as a right, it would enhance full freedom. It would also strengthen the bargaining position of disadvantaged groups, who usually have to accept degrading conditions and low wages because they are desperate. From an economic viewpoint, it would shift money into the hands of those most likely to spend on locally produced goods and services, thus boosting local demand and employment.

Compared with means-tested social assistance and social insurance, a universal cash transfer would remove the infamous poverty trap, whereby someone who raises their income just above the threshold used to determine eligibility for the cash transfer loses all benefit, and the related unemployment trap. As such, it would immeasurably reduce the incidence of both moral and immoral hazards.

There is another reason for thinking that universal basic income security will ultimately emerge as the sensible and equitable objective from experience with targeted, conditional cash transfers. Surveys in many countries have found that strong majorities of people believe that everybody should have basic income security as a right (ILO, 2004: Chapter 13).

Apart from the moral and political arguments, there are good economic and social reasons for moving towards basic economic security. Universal schemes of security are market neutral, i.e., they do not introduce market distortions and so have little effect on competitiveness. Unlike means-tested social assistance, universalistic schemes do not introduce negative incentives to dis-save (which would merely store up economic vulnerability), and there is no tendency to reward “labour” relative to other forms of work. And experience of cash transfer schemes has shown that far from breeding dependency and passivity, they foster independence and activity. Thus, one study, drawing on surveys conducted by Statistics South Africa (the official agency for statistics), showed

that the country's old-age pension, the Child Support Grant and the Disability Grant all raised labour force participation and employment (Samson, Lee, van Niekerk and MacQuene, 2004).

Moreover, universal schemes are administratively simpler and less costly. There is relatively little scope for bureaucratic abuse, discretion or corruption. The benefits are non-stigmatizing and, being universal, they help strengthen social solidarity, reinforcing community and social cohesion.

In reality, the cost of cash transfers is not the primary issue, since even poor countries could afford modest schemes, and most could do so relatively easily if more aid were diverted to that end. In a simulation study, the UNDP found that cash transfers targeting all rural children rather than only poor children would have a greater poverty reduction effect for an allocation of just 0.5 per cent of GDP (Kakwani, Soares and Son, 2005). The study reckoned that cash transfers to achieve an income of 40 per cent of the poverty line would cost 5 per cent of GDP for the Ivory Coast and more for some other African countries. But even small cash transfers would have a big effect in reducing poverty in all the 15 countries studied.<sup>7</sup>

In sum, the current surge to CCTs may be a step on the road to universal basic income security through universal cash transfers, as a means of restoring an emancipatory egalitarianism as the central goal of development.

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## NOTES

- 1 For detailed rationale for these principles, see Standing (2002); ILO (2004).
- 2 A series of People's Security Surveys in Africa and Asia found that it was the near-poor who were more likely to be aware of such schemes and more likely to benefit from them (ILO, 2004).
- 3 Self-selection has been advocated by some prominent economists. This is morally bad. As if the poverty were not enough, this implicitly favours a public display of humiliation.
- 4 The original scheme was called the programme for education, health and nutrition, symbolizing its multiple objectives. For details on targeting and means-testing, see Standing (2008).
- 5 See Standing (2008) for details.
- 6 On the South African situation, see Nattrass (2006a, 2006b).
- 7 Other simulation studies have found that in countries such as Namibia and South Africa, a modest basic income as a monthly grant would be affordable, and at least one government committee in South Africa has recommended its introduction. See, for example, the papers in Standing and Samson (2004) and Taylor Committee (2002).





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