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**ACCELERATING PRO-POOR GROWTH THROUGH SUPPORT FOR PRIVATE SECTOR  
DEVELOPMENT**

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*The attached note is a product of Phase I of the work of the task team on private sector development (led by DFID). It provides BACKGROUND to the discussion of item 5.a of the draft POVNET agenda. The note presents an analytical framework for addressing how private sector development can contribute to promoting pro-poor growth. This framework provides a foundation for Phase II of the work of the task team (led by SIDA) which will identify and develop policy recommendations on how donors can best promote the contribution of the private sector to pro-poor growth.*

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***Accelerating Pro-Poor Growth  
Through Support For  
Private Sector Development***

***An Analytical Framework***

**Working document**

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## Preamble

***'The private sector is where much of our focus is going to have to be to meet the overarching challenge of poverty reduction and human development. Growth, jobs and opportunity belong there not in the gift of government'.<sup>1</sup>***

With just over a decade left to 2015, the governments of developing countries and their donor partners are challenged to achieve the first Millennium Development Goal (MDG1) of halving the proportion of people with incomes below \$1/day (MDG1). In many countries, progress in reducing income poverty has been slow, and the danger of failing to deliver on the Goal is all too evident. What is less clear, however, is how to bring about the dramatic change in the rate of poverty reduction that will give them hope for fulfilling the Goal.

In 1995, the Development Assistance Committee (DAC) of the OECD published the *DAC Orientations for Development Co-operation in Support of Private Sector Development*. The Orientations focused on the policies and programmes required for the private sector to promote economic growth and deliver sustainable development in developing countries. In 2001, OECD published the *DAC Guidelines: Poverty Reduction* which provide a robust framework for reducing poverty. These Guidelines recognise the importance of 'vigorous, sustained economic growth in the private sector' for providing jobs and incomes for the poor. Subsequently, other organisations have published reports on how to establish a dynamic private sector and what constitutes pro-poor growth.<sup>2</sup>

This document builds on the DAC publications and recent reports by elaborating how pro-poor growth, essential for the achievement of MDG1, can be accelerated through support for private sector development. It provides an analytical framework for the staff of development agencies and concerned governments to help them understand the factors that matter for pro-poor growth and the processes for bringing them about. Subsequent documents will focus on key issues in providing support for private sector development to accelerate pro-poor growth.

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<sup>1</sup> Mark Malloch Brown, Administrator, UNDP. Poverty Reduction, the Private Sector and the Millennium Development Goals: A New Framework for a new Future. January, 2003.

<sup>2</sup> For instance *Unleashing Entrepreneurship: Making Business Work for the Poor*. A report to the Secretary General, UN, 2004 and various studies on pro-poor growth referred to in Chapter 1.

## Summary

### Pro-Poor Growth And The Private Sector

The rate at which the average income of the poor is rising will determine whether countries will achieve MDG1. The rate is made up of a growth and a distributional component. Whilst growth is necessary for the incomes of the poor to rise, to maximise pro-poor growth, the distribution component should complement the growth component. It is not necessary to trade-off growth against distribution. In countries in danger of failing to meet MDG1, the contribution of the growth component may be low and/or the poor fail to benefit proportionately from growth. Their disadvantage in benefiting from growth may be caused by high levels of inequality and patterns of growth that result in sectors and regions in which they are active lagging the rest of the economy whilst growing sectors and regions fail to provide sufficient, rewarding opportunities that the poor can access.

The private sector includes the poor as well as businesses and is the engine of growth. Risk taking to earn profits and incomes provides the motivation for private actors, including the poor, to participate in markets, driving growth. The poor potentially benefit from growth as workers, farmers and entrepreneurs, consumers and recipients of tax-funded basic social services and transfers. Market outcomes influence both the rate and pattern of growth, determining the extent to which the poor are provided with opportunities to benefit from growth. Institutions determine the rules of the game for markets and the governance exercised over them and so have a major influence on market outcomes. They have a crucial role to play also in ensuring the long term sustainability of development. Policies to enable the poor to benefit from the opportunities provided by a growing economy influence the extent to which market outcomes are pro-poor.

### Accelerating Pro-Poor Growth

Achieving rapid and sustained growth depends upon the extent to which five key factors are present to provide an enabling environment for private sector development:

1. Providing Incentive for Entrepreneurship and Investment
2. Increasing Productivity: Competition and Innovation
3. Harnessing International Economic Linkages
4. Improving Market Access and Functioning
5. Reducing Risk and Vulnerability

Institutions and policies to develop an enabling environment for private sector development influence not only the rate of growth but also the extent to which the pattern of growth provides opportunities for the poor to improve their incomes. To accelerate pro-poor growth, appropriate institutions and policies for private sector development need to be accompanied by policies that address inequality in access to the basic services of health, education and infrastructure, and the terms on which the poor access markets that matter for their livelihoods and empower them to escape the poverty trap.

Entrepreneurship and investment influence the rate and pattern of growth. Rates of entrepreneurship and investment vary substantially between countries, with low rates associated with poorer countries. Incentive, the perceived balance between risk and reward, drives individuals and businesses to invest in entrepreneurial activities. Institutional change and policies that lower the risk and cost of doing business and provide greater access to productive resources increase the incentive for entrepreneurship and investment and lead to a pro-poor pattern of growth, particularly if they establish a level playing field for the poor. If the level of incentive is low, growth is likely to be confined to a

few sectors and regions and the poor are less likely to benefit from growth. Informality, caused by inappropriate institutions and policies for entrepreneurship and investment, is widespread in the poorer countries and is associated with high rates of poverty incidence.

Rapid and sustained growth is facilitated by a virtuous circle whereby entrepreneurship and investment lead to higher productivity, which increases the return on investment, making it possible to invest larger sums in the future and for wages to increase. Productivity increases through a process of creative destruction, brought about by competition, by which innovators replace the less efficient. For productivity to increase, productive resources should also flow to sectors in which they earn the highest returns, facilitated by appropriate institutions for regulating markets and ensuring equitable and sustainable natural resource use. To accelerate growth that is particularly pro-poor, productivity needs to rise in sectors from which the poor earn their livelihoods and in the sectors that provide new opportunities for them to participate in and benefit from growth, supported by institutions to disseminate knowledge and policies to invest in the productive assets of the poor.

Rapid growth is associated with greater international economic linkages of trade and investment. Greater trade integration enables the economy to focus resources on sectors of competitive advantage, and enables the private sector to access large and rapidly growing markets for international trade, stimulating productivity – particularly if accompanied by greater foreign direct investment (FDI). However, reducing tariff barriers and attempting to attract FDI has not proved sufficient for many developing countries to benefit from greater international linkages. These countries need to examine whether there are sufficient incentives for businesses to compete in international markets, appropriate institutions and infrastructure to facilitate trade and that resources are able to flow to sectors of comparative advantage. To contribute to pro-poor growth, the poor need to be enabled to benefit from trade and FDI by improving their access to markets and helping them to diversify their sources of livelihoods, including reducing their reliance on commodities with falling real prices. Safety nets may need to be provided for the poor who stand to lose from trade liberalisation.

Whilst the above will lead to higher growth and provide opportunities for the poor, the benefits for the poor may be increased by improving access to well functioning markets that matter for the livelihoods of the poor. In these markets, the poor should, ideally, participate on equal terms with the rest of the private sector. Access to and the functioning of markets for productive resources is vital for pro-poor growth. Increased private credit, higher rates of formal employment, security of use and higher productivity on a sustainable basis of natural resources, are causal factors of pro-poor growth. The poor benefit from them directly, through improving their current livelihoods, and indirectly, by providing opportunities to diversify livelihoods. Outcomes in markets for other inputs the poor use to earn livelihoods and value chains for goods and services they produce and consume also affect the extent to which growth is pro-poor.

Improving access and functioning depends upon developing appropriate market regulating, facilitating and promoting institutions, addressing market failures, lowering transaction costs, reducing social exclusion and addressing underdeveloped functions of value chains to provide better outcomes for the poor. Institutions should be designed to create a level playing field for the poor. For growth to be pro-poor, institutional change may need to be accompanied by policies aimed at empowering the poor to use the opportunities that a market economy offers. The provision of basic social services of health, education and infrastructure and actions to empower women, such as female literacy, are particularly pro-poor.

The poor are vulnerable to man-made shocks and natural disasters, and their strategies for mitigating and coping with risk may prevent them from increasing their incomes. The poor may be caught in poverty traps caused by their lack of access to livelihood assets. Political, economic and social stability reduce risk for the poor. Improved access to markets for productive resources helps them cope with shocks better, helping to reduce the incidence of child labour for instance. Mechanisms to insure risk to livelihoods and safety nets for the vulnerable reduce the extent of risk management strategies that result in lower incomes. There is an economic case for reducing poverty traps through increasing access to assets for the economically active and 'smart transfers' for those disadvantaged by sickness or old age. In the event of man-made or natural shocks, such transfers may prevent the poor from adopting coping strategies that prevent them increasing incomes in the future.

### **Delivering Pro-Poor Change**

Institutions and policies result from the interaction of the state, the private sector and civil society. The state, the private sector and civil society consist of groups and organisations that wish to promote institutions and policies that serve their own interests and may neglect the interests of the poor. It may be necessary for progressive elements within the three parts of society, in conjunction with donors, to highlight the plight of the poor and provide evidence of how pro-poor growth benefits society in the long term, both in terms of growth and social cohesion.

Delivering pro-poor change involves addressing issues of political economy and so needs to be approached with sensitivity. For pro-poor institutional and policy change to succeed, it may be necessary to help build constituencies for change over a specific issue, comprising like-minded organisations and individuals. These constituencies need to be enabled to engage with vested interest to overcome resistance to change. Analysis of stakeholder interests, including who stands to win and lose from change and what their specific interests are, should help to reveal how to vested interests may be overcome. The constituency may need to overcome resistance to change through evidence-based dialogue, piloting reforms and, if necessary, finding ways to compensate the losers.

The priorities for and sequencing of institutional and policy change depends upon the attitudes and perceptions of the principal actors in the specific context. Engagement between the state, the private sector and civil society should help identify priorities. The Poverty Reduction Strategy Paper (PRSP) process represents an opportunity to institutionalise such engagement. At present PRSPs frequently do not set specific benchmarks for PSD and do not involve the private sector and civil society in monitoring outcomes. If possible, stakeholder engagement should include participatory monitoring and learning in which the views of the intended beneficiaries, including the poor, help to influence the future course of action and thereby set in motion a continuous process of improving institutions and policies.

## Donor Support in the New PSD Agenda

This paper suggests that the agenda for accelerating pro-poor growth through support for private sector development is broader than the old private sector development agenda, which mainly focused on providing support to private sector enterprises that were considered important for the livelihoods of the poor, particularly small enterprises. Evidence suggests that a higher contribution by small enterprises<sup>3</sup> to an economy is associated with, but not a cause of, higher growth and may not necessarily be pro-poor. It is market outcomes that may be more or less pro-poor, not particular types of enterprise. The new agenda recognises that what matters for pro-poor growth is the extent to which the rate and pattern of growth and outcomes in markets that matter for their livelihoods provide opportunities for the poor and they are enabled to take advantage of these opportunities. The focus is thus on institutions and policies that influence market outcomes.

The aim of practitioners should be to bring about systemic change, altering the incentives provided to the private sector in order to make it deliver pro-poor outcomes. Systemic change is likely to involve a combination of institutional and policy change and support for accelerating the development of markets that poor the need to improve livelihoods. This approach is being adopted progressively in the main types of private sector development support that donors provide. Thus, in the provision of businesses development services (BDS), there is a growing recognition that BDS provision is not an end in itself but a tool to bring about pro-poor outcomes in markets that matter for the poor, to support regional development, and to target specific beneficiaries such as women. It may involve both large and small enterprises.

For the purpose of long-term sustainability, it is preferable that donors attempt to change the system without becoming part of the system. For institutional change, donors may foster the emergence of change agents who can build constituencies for change, overcome vested interest and institutionalise stakeholder engagement with participatory monitoring and evaluation. To improve the supply of goods and services, they may use facilitators to catalyse the development of markets intervening pre and post delivery. In this way, the sustainability of the intervention will be driven by market forces.

Instead of regarding private sector development as one of a number of tools for supporting partner governments, accelerating pro-poor growth through support for private sector development should be regarded as a major, if not a central, part of the country assistance they provide. Within the donor agency, accelerating pro-poor growth through private sector development should be a cross cutting issue and expertise in this field placed within the organisation so it may support all country facing departments, akin to a policy function. The range of skills for the function should be wider than enterprise development and finance for small enterprises, encompassing also macroeconomics, governance and institutional change, and policies towards the provision of basic social services and transfers to reduce poverty traps.

The uncertainty of progress on delivering institutional change and bringing about pro-poor outcomes means that donors will need the greater flexibility that programmes provide over projects, allowing the sequencing of support to be altered if necessary. Moreover, the new broader agenda calls for greater donor co-ordination, through sector wide approaches that involve the private sector and the poor. It is unlikely that a single donor will have the resources or competitive advantage in supporting the delivery of all conditions that contribute to pro-poor growth. By co-ordinating with other donors, they will be able to ensure the breadth of interventions required for their programmes is effective.

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<sup>3</sup> Micro, small and medium enterprises.

## **Chapter 1: Pro-Poor Growth and the Private Sector**

*The multiple dimensions of poverty may be addressed through pro-poor growth. This chapter explores how accelerating pro-poor growth through support for private sector development can contribute to achieving the MDG of halving the proportion of poor people (MDG1). It considers what we mean by pro-poor growth, what influences its rate and what is the role of the private sector in accelerating pro-poor growth.*

### **I. Poverty Reduction and Pro-Poor Growth**

The DAC Poverty Reduction Guidelines and other frameworks for poverty reduction<sup>4</sup> describe the many deprivations that the poor experience. In addition to low incomes, the poor suffer from a lack of an effective ‘voice’ in shaping policies that affect their lives, a lack of access to assets that undermine their capability to earn livelihoods, discrimination on the basis of gender or social group and vulnerability to natural and man-made shocks and disasters. To address these multiple dimensions, the Poverty Reduction Guidelines state that a strategy for the sustainable reduction of poverty must include the following six complementary policy elements:

*...poverty is multiple forms of deprivation ...*

#### **Box 1: The Framework for Poverty Reduction**

- Pro-poor economic growth: pace and quality matter – its rate, composition, distribution and sustainability are vital for reducing income poverty;
- Empowerment, rights and pro-poor governance – the poor need to be able to exercise their human and political rights to influence their own lives and the system of governance should protect those rights;
- Basic social services for human development such as access to health, education and transport, safe water and adequate nutrition;
- Human security: reducing vulnerability and managing shocks. Human security means safeguarding human development by protecting people from shocks and disasters;
- Mainstreaming gender and enhancing gender equality. Gender inequality is a major impediment to sustainable development; and
- Mainstreaming environmental sustainability using sustainable livelihood approaches. Achieving the MDGs calls for an integrated approach combining economic and social development and environmental sustainability.

The pace and quality of economic growth have a direct bearing on reducing income poverty, and they also influence the ability to bring about the other elements of the framework for reducing poverty:

- The pace of growth affects the revenues available to governments to fund the basic social services that the poor need to lead productive lives.
- Growth may empower or deprive the poor economically and this may increase or decrease their ability to influence the policies and institutions that affect the pattern and distribution of growth.
- The sustainability of growth influences the extent to which the poor are exposed to economic shocks.

*The pace and quality of growth impact all aspects of poverty*

<sup>4</sup> For instance, see World Development Report 2000/1 Attacking Poverty, World Bank.



- The inclusiveness and equity of the growth process determine the extent of economic discrimination against women, who make up a disproportionately high proportion of the poor.
- The nature of the growth process affects resource use and the extent to which environmental sustainability is integrated with economic and social development.

## II. What is Pro-Poor Growth?

But what, precisely, do we mean by pro-poor growth and how should it be measured?

There are different views on what constitutes pro-poor growth. For some,<sup>5</sup> growth is pro-poor when the incomes of the poor are rising more than average incomes, thus showing that the poor are benefiting disproportionately from growth and that inequality between the poor and the non-poor is falling. This is the relative definition of pro-poor growth. For others,<sup>6</sup> what matters is the rate at which the incomes of the poor are rising. This is the absolute definition of pro-poor growth. It recognises that the growth in the incomes of the poor determines when their incomes will exceed \$1/day, crucial for achieving MDG1. Governments and donors have a choice as to how they define pro-poor growth. In practice, practitioners may refer to both definitions, the absolute when discussing the reduction of the headcount poverty index (and the achievement of MDG1) and the relative when assessing the extent to which inequality is changing during the growth process.

At the heart of both the absolute and relative definitions of pro-poor growth is a concern with an increase in the incomes of the poor. But what is the right measure of the rate at which the incomes of the poor are rising? Again, practitioners have a choice in this regard. They may focus on the incomes of those who are marginally poor, as this is the crucial measure for reducing the poverty headcount, or the rate at which the gap between the incomes of the extreme poor and incomes at the poverty line is falling to assess how long it will take to eradicate poverty.<sup>7</sup>

However, a consensus seems to be emerging that the appropriate measure is the growth of the average incomes of all poor people, i.e. all people below the (national or international) poverty line.<sup>8</sup> This focuses attention on policies that ensure that all sections of the poor benefit from growth, not just those nearest the poverty line or indeed those furthest away. Other measures are also useful and may be referred to when examining, for instance, the time it will take to eradicate poverty.

The critical point that emerges from the absolute definition is that pro-poor growth is a rate not a state, and so practitioners need to address how it may be increased. It should be noted, however, that there are major limitations on the availability and quality of data to measure the rate of pro-poor growth across time periods and countries.<sup>9</sup>

*Monitoring the rate of growth in the average incomes of the poor reveals whether MDG1 will be met*

*Growth of average incomes is a necessary condition for poverty reduction but the effect of growth on the incomes of the poor varies substantially*

## III. What Determines the Rate of Pro-Poor Growth?

There is now widespread agreement that increasing average incomes (GDP per capita) is a necessary condition for reducing poverty and that the higher the rate of

<sup>5</sup> For example, Klasen, S. In Search of the Holy Grail: How to Achieve Pro-Poor Growth, 2003.

<sup>6</sup> For example, Ravallion, M. and Chen S. Measuring Pro-Poor Growth, Economic Letters (78), 2003.

<sup>7</sup> Klasen S. 2003

<sup>8</sup> Ravallion M & Chen S. Measuring Pro-Poor Growth, 1997.

<sup>9</sup> Guidance on how the rate of pro-poor growth can be calculated is available from DFID (email: [growth@dfid.gov.uk](mailto:growth@dfid.gov.uk)).

growth, and the longer sustained, the more rapid poverty reduction.<sup>10</sup> Across countries and time periods, it has been found that, as average incomes rise, the incomes of the poorest fifth of the population<sup>11</sup> rise proportionately. Over long time periods, between 66-90% of the reduction in poverty can be explained by changes in average incomes.<sup>12</sup>

But the effect of growth on the incomes of the poor varies substantially between countries and time periods.<sup>13</sup> There are examples of periods of growth in individual countries that have not had much impact on poverty.<sup>14</sup> Such episodes draw attention to the issue of the extent to which the poor benefit from growth.

Figure 1

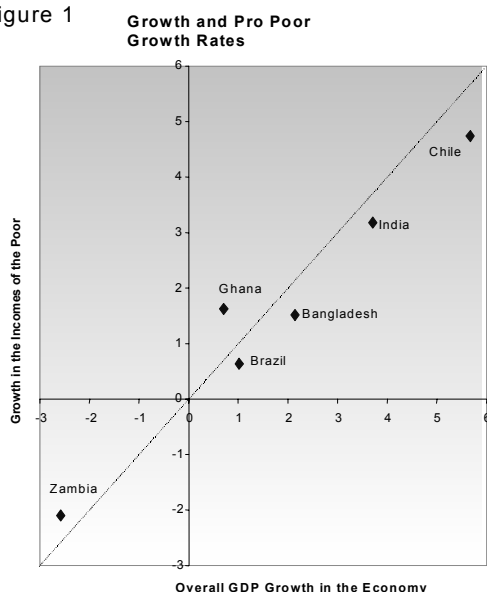


Figure 1 shows that the relationship between the growth of average incomes and the growth rate of the incomes of the poor varies significantly across countries.<sup>15</sup> Whilst growth in average per-capita incomes was similar in Brazil and Ghana, the incomes of the poor rose twice as fast in the latter. As a result, inequality between the poor and the non-poor fell in Ghana as it did in all countries above the 45-degree line, but increased in Brazil and other countries below the 45-degree line.

The rate of poverty reduction is a combination of a growth and a distribution component.<sup>16</sup> The growth component measures the extent to

which the incomes of the poor would have risen as a result of growth if the distribution of income had remained unchanged. The distribution component measures the effect on the incomes of the poor of changes in the distribution of income.

The two components may work in the same or opposite directions, and the net effect on poverty will depend upon their relative magnitudes. Hence, in Vietnam and China, substantial reductions in poverty have been achieved through rapid growth, even though the distribution component has been negative. If both are roughly equal in magnitude and work in opposition, poverty reduction will be low. For example, in Ethiopia, between 1981-95, growth should have resulted in poverty reduction of 31%. In practice, a negative distributional effect of 37% resulted in a net increase in poverty incidence of 6%.<sup>17</sup> It is important to consider growth and distribution simultaneously and to recognize that, though growth is necessary, distribution may matter as much as growth for poverty reduction.<sup>18</sup>

<sup>10</sup> Kraay, A, When is Growth Pro-Poor, World Bank, 2003.

<sup>11</sup> Dollar D. & Kraay A. Growth is Good for the Poor, World Bank, 2003.

<sup>12</sup> Kraay, A. 2003

<sup>13</sup> Ravallion M. Growth, Inequality & Poverty: Looking Beyond Averages (2001)

<sup>14</sup> Bourguignon F., The pace of Economic Growth & Poverty Reduction, 2001

<sup>15</sup> DFID Briefing Note Number 1, 2004.

<sup>16</sup> Bourguignon, F. The Growth- Inequality-Poverty Triangle, Feb 2004.

<sup>17</sup> Bourguignon F. 2004

<sup>18</sup> Bourguignon F. 2004

The critical point to note is that it may not be necessary to trade-off the growth against the distribution component. It is possible to have higher growth that impacts positively on distribution. Evidence from across the world shows that inequality falls almost as often as it increases with growth.<sup>19</sup> What is important is to identify the conditions under which the two components complement each other.

What factors affect the magnitude and direction of each component?

There is mounting evidence that high initial levels of inequality in incomes and access to productive assets lower the rate of growth and hence the growth component of the incomes of the poor, and increases the likelihood of the distributional component having a negative impact on poverty reduction.<sup>20</sup> Countries with high rates of initial inequality need higher rates of growth to reduce poverty at the same rate as those with lower initial inequality.

In addition, the pattern of growth in geographical and sector terms also has an effect. If growth is broad-based, encompassing the whole country and economy, it is likely to be faster and provide greater opportunities for the poor to increase their incomes, thus contributing to a positive distribution component. Economic growth in the regions in which the poor live and sectors from which they earn incomes is likely to positively impact the incomes of the poor directly. In many countries that have substantially reduced income poverty, increased agricultural productivity has been a strong factor in increasing the incomes of the poor and contributed to the structural transformation of the economy by facilitating new sectors to eventually lead growth.<sup>21</sup> For the growth and distributional components to complement each other, it is important also that the poor have the opportunity to participate in and benefit from rapidly growing regions and sectors.

#### IV. How do the Poor Participate in and Benefit from Growth

The poor are participants in the growth process alongside the non-poor. Potentially, growth should benefit the poor in the following ways:

- *As farmers and entrepreneurs*, they should benefit from greater demand for their products and services. The impact on the incomes of the poor will be greatest if they have access to the assets that they need to earn their livelihoods, the productivity of those assets increases and if they are able to take advantage of opportunities provided during the growth process.
- *As workers*, they benefit from greater demand for labour, more jobs and higher wages. These benefits would increase if growth occurs in sectors that are labour intensive, or if labour demand increases in sectors in which many of the poor participate and higher productivity enables higher wages to be paid.
- *As consumers*, they should benefit from lower prices and better quality products that come with higher, more efficient production. These benefits would be greater if suppliers were to produce cheaper goods and services, and the high costs of serving poor consumers, particularly in rural areas, could be reduced.
- *As potential recipients of tax-funded services or transfers*, they should benefit from a stronger tax base that enables higher expenditure by government. Better access to basic social services of health, education, safe water and adequate

*...'.PSD is fundamentally about people releasing and harnessing their productive potential and satisfying their human needs.'*

<sup>19</sup> Ravallion M. Pro-Poor Growth: A Primer.

<sup>20</sup> Ravallion M. Pro-Poor Growth: A Primer .

<sup>21</sup> Reaching Millennium Goals: How well does agricultural productivity growth reduce poverty? Noman Majid, ILO 2004.

nutrition would enable the poor to improve their opportunity to earn livelihoods as farmers, entrepreneurs and workers whilst improved infrastructure would improve access to all markets.

## V. The Private Sector and Pro-Poor Growth

What is the private sector and what role does it play in delivering pro-poor growth?

Whilst for many the term private sector conjures up the image of a business engaged in commerce or manufacturing, analysing the characteristics of the private sector leads to a deeper understanding of its nature and widens the coverage of the term.

The DAC Orientations define the private sector as ‘a basic organising principle of economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk taking set activities in motion’. The critical point made is that it is markets, through the process of competition, that determine what is produced and consumed. This is what distinguishes market-based economies from other organising principles.

In market economies, it is risk taking to earn profits and incomes, by private sector actors, which sets economic activity in motion. Such motivation is not just confined to businesses. It is the motivation also for individuals and households when they sell their labour, farm or produce other goods and services. The term private sector, therefore, covers all private actors - the poor and the rich, individuals and businesses - engaged in risk taking to earn profits and incomes through market exchange. It applies to the smallholder farmer as well as to the very large, multinational corporation.

The world over, the private sector is the major contributor to GDP and jobs and so is the engine of the economy. Growth, as measured by increases in GDP, is simply the sum of the increase in value added by the activities of all participants engaged in production and market exchange.<sup>22</sup> The greater the capability of private actors, including the poor, to add value and create wealth, the faster will be the pace of growth.

Market outcomes have a strong bearing on whether growth is pro-poor. They provide the signals to the private sector that affect the pace and pattern of growth. The ability of the poor to increase incomes is influenced by outcomes in markets in which they participate.

## VI. The Role of Institutions & Policies in Pro-Poor Growth

What makes for pro-poor outcomes in markets?

The critical determinants of whether market outcomes are pro-poor is the terms on which the poor are able to access markets. The terms of access may either disadvantage the poor, establish a level playing field with the rest of the private sector, or empower them to take advantage of opportunities provided by growth.

*The private sector is more than businesses. It includes the poor and multinationals participating alongside each other in markets*

*PSD is the interplay between the State as formulator of the rules of the game, players in the private sector and civil society. Sida: Making Markets Work for the Poor.*

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<sup>22</sup> Simply put, growth is the sum of the increase in value added (outputs less bought in goods and services) across all economic activities in an economy.

Institutions<sup>23</sup> play a pivotal role in influencing the terms of access and hence market outcomes. Markets need appropriate 'rules of the game' to ensure that they function efficiently and allow a stable, secure and fair exchange. Such rules need to be applied transparently, fairly and efficiently to ensure effective governance. Institutions, the rules of the game and the governance exercised over them, may serve to promote market exchange or deny access. For example, the absence of appropriate regulatory institutions may reduce the motivation of the private sector (including the poor) to engage in economic activity, reducing growth or making growth less pro-poor. Institutions may serve to link and empower actors, particularly the poor, or marginalise them from the growth process. The poor start from a disadvantaged position in terms of wealth and incomes compared to the rest of the private sector. Promoting and facilitating institutions may help to ensure that this disadvantage does not become a 'poverty trap',<sup>24</sup> excluding the poor from the growth process.

Institutions may also play the crucial role of ensuring sustainable development in which growth is accompanied by social cohesion and environmental sustainability. Sustainable development contributes to pro-poor growth by providing access to natural and social assets. Institutions, both formal and informal, may help to ensure that social conflict, particularly over the use of natural resources or access to markets, is reduced. Such conflict often reduces growth and results in exclusion, almost always for the poor. Institutions may ensure that price signals reflect the true cost or benefit of using or conserving natural resources,<sup>25</sup> providing the motivation for the private sector to manage environmental impacts. Appropriate institutions help to ensure that the private sector, in recognition of its role as a corporate citizen, takes account of social and environmental impacts whilst maximising wealth creation.

Policies with respect to the way that tax-funded transfers are used also impact terms of access. Thus, if the government addresses initial inequality suffered by the poor with respect to access to productive assets and basic social services of health, education and infrastructure, it will help to level the playing field in the terms of access. Investment in developing the skills of the poor to enable them to take advantage of opportunities provided by growth will empower them to increase incomes.

## VII. In Summary

Pro-poor growth addresses income poverty and influences also the ability to bring about other elements of the framework for poverty reduction. For growth to be pro-poor, what matters is that the rate of growth is high, that the pattern of growth provides opportunities for the poor to increase their incomes, and that they are enabled to take advantage of these opportunities. The growth and distribution components of the rate of pro-poor growth are not in contradiction, and to maximise the rate, practitioners need to identify the conditions that allow the two components to complement each other. The pace and pattern of growth are influenced by the signals the private sector, including the poor, receives through market outcomes. Market outcomes are influenced by institutions and policies, and these may be more or less pro-poor.

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<sup>23</sup> Throughout this paper, the term institutions is used to mean the rules of the game (formal and informal), the governance exercised over their implementation and the organisations responsible for that governance. See WDR 2002 Building Institutions for Markets.

<sup>24</sup> Dercon, S. Poverty Traps & Development: The Equity-Efficiency Trade-off Revisited, 2003.

<sup>25</sup> Markets for trading carbon emissions are an example of institutions that reinforce the conservation of natural resources.

## **Chapter 2: Accelerating Pro-Poor Growth**

*In some countries, the challenge is to increase economic growth, on a sustained basis, to levels that have never been achieved before. In others, there is a need to ensure that growth is more pro-poor than heretofore. This chapter provides an analytical framework for understanding what factors enable the private sector to accelerate growth and what institutions and policies help to make growth pro-poor.*

As country contexts differ widely, it is difficult to arrive at a universally applicable set of policies<sup>26</sup> and forms of institutions<sup>27</sup> that ensure pro-poor growth. What is possible, however, is to provide an analytical framework to assess whether conditions are in place for the private sector to deliver growth, and to identify changes to institutions and policies that help to make growth more pro-poor. The analytical framework consists of five interlinked factors:

1. Providing Incentive for Entrepreneurship and Investment
2. Increasing Productivity: Competition and Innovation
3. Harnessing International Economic Linkages
4. Improving Market Access and Functioning
5. Reducing Risk and Vulnerability

***Five interlinked factors form an enabling environment for the private sector to deliver growth***

These factors represent an enabling environment for the private sector to deliver growth. Institutions and policies for private sector development that help to bring them about influence also the pattern of growth determining the opportunities for the poor to improve their livelihoods. To make growth more pro-poor, institutions and policies for private sector development need to be accompanied by institutions and policies that address the terms on which the poor access markets, help to empower the poor to take advantage of these opportunities, and deliver public goods such as social inclusion and environmental sustainability that also impact the sustainability of growth.

### **I. Providing Incentive for Entrepreneurship and Investment**

#### **a) How does providing incentive for entrepreneurship and investment affect the rate of pro-poor growth?**

In search of profits and incomes, entrepreneurs<sup>28</sup> set economic activity in motion by bringing together productive resources to produce goods and services. Entrepreneurship requires investment to bring together factors of production. Investment contributes to growth by increasing the productive capacity of the economy, creates jobs, and, as it is an instrument for introducing new technology, it serves to increase the productivity of other factors of production.<sup>29</sup> It is the wealth created through these activities that results in growth.

***Entrepreneurship and investment affect the rate of growth and influence its pattern***

Rates of entrepreneurship vary tremendously across countries. For instance, Ukraine has less than 10 enterprises per thousand population compared to 120 in Thailand.<sup>30</sup> Countries with high rates of entrepreneurship are likely to have dynamic private sectors, better able to deliver and sustain high rates of growth. A high rate of investment is one of the key differentiating factors of countries that have enjoyed

<sup>26</sup> See for instance, Easterly W., *The Elusive Quest for Growth-Economists' Adventures and Misadventures in the Tropics*, 2001.

<sup>27</sup> Rodrik, Dani. *Growth Strategies*, Harvard University, 2003 discusses differences in institutional arrangements

<sup>28</sup> Entrepreneurship refers to risk taking by both individuals and firms.

<sup>29</sup> Source: Kauffman Foundation

<sup>30</sup> Source: Kauffman Foundation

high rates of sustained growth. In countries with high rates of growth, investment typically exceeds 25% of GDP, whereas it struggles to reach 20% in low growth countries. Where investment is low, 14% of GDP in Bolivia for instance,<sup>31</sup> the productive capacity of the economy fails to increase, resulting in lower rates of growth and job creation, resulting in fewer opportunities for the poor to improve their livelihoods.

## **b) What factors influence the rate and pattern of entrepreneurship and investment ?**

The concept of *incentive* is critical to understanding the motivation of the private sector to engage in entrepreneurship and to undertake investment. Incentive refers to the balance between anticipated risk and reward, not just the tax incentives given to business. The higher the risk, the greater the profitability of the venture has to be to justify the investment. The higher the costs of transactions<sup>32</sup> (doing business), the higher the potential returns have to be before these costs are taken into account. Both risk and transaction costs thus reduce the incentive for entrepreneurship and investment.

*Risk and transaction costs reduce entrepreneurship and investment*

Institutions are critically important for determining the level of risk and costs of doing business. The risk of doing business is likely to be lower if the rules of the game are transparent, predictable and well enforced, through good governance, if there is security over rights to property and other assets used for investment, and there is a level playing field in competing against other businesses. The cost of doing business is affected by the level of barriers in starting, operating and closing businesses, bureaucracy involved in doing business, access to and the cost of infrastructure and the cost of enforcing contracts that govern transactions.

*Transparent and predictable rules of the game, along with good governance, reduce risk. Simpler business regulations and improved access to infrastructure reduce the cost of doing business*

Rates and patterns of entrepreneurship and investment are affected also by access to productive resources. Access to capital is fundamentally important to entrepreneurship and investment as it enables the mobilisation of all productive assets. Lack of access to capital limits entrepreneurship and investment. The greater the flexibility of labour use and the higher the level of human capital of the work force, the more incentive entrepreneurs have to employ labour and hence provide opportunities for the poor to find jobs.<sup>33</sup> The easier it is to establish and transfer title to land, the more likely it is that it can serve as collateral to raise capital. Access to other natural resources, such as forests, water, clean air, helps to provide opportunities for entrepreneurship and investment, but the use of natural resources must be sustainable to avoid incomes falling as the quality of resources declines.

Where there are high risks and costs of doing business and limited access to productive resources, entrepreneurship and investment are likely to be limited to the few sectors and regions that offer rates sufficiently high rates of return to offset them. The poor are likely to be most disadvantaged as they are frequently suffer higher governance risk and cost of doing business and lower access to productive resources. Hence, the opportunities growth provides for the poor to improve livelihoods is likely to be lower. It is the case that the poorer countries tend to have less transparent and predictable rules of the game, ineffective governance<sup>34</sup> and limited access to productive resources. Institutions and policies that address these

*High risk and cost of doing business will confine growth to a few sectors and regions making growth less pro-poor*

<sup>31</sup> Countries at a Glance: Bolivia, World Bank.

<sup>32</sup> Transaction costs – The costliness of information is the key to the costs of transacting, which consists of measuring the valuable attributes of what is being exchanged and the costs of protecting and policing and enforcing agreements.

(Douglass North, 1990)

<sup>33</sup> World Development Report 2005, Draft chapter 7, World Bank.

<sup>34</sup> See for instance, Doing Business in 2004, Michael Klein, World Bank 2004.

shortcomings and help to bring about a level playing for the poor in engaging in entrepreneurship and to undertake investment help to make growth pro-poor.

The main institutions and policies that affect entrepreneurship and investment are set out in Box 2 below.

### Box 2

Institutions & Policies for Entrepreneurship and Investment	Effect on Pro-Poor Outcomes
<p><b>Entry &amp; Exit Barriers</b></p> <ul style="list-style-type: none"> <li>▪ Ease of business establishment</li> <li>▪ Ease of bankruptcy procedures</li> <li>▪ Less bureaucracy</li> </ul>	<ul style="list-style-type: none"> <li>▪ Reducing barriers to establishing, operating or closing businesses, in the form of numerous or costly procedures and bureaucracy, reduces risk and cost of doing business, increasing the incentive for entrepreneurship and investment</li> <li>▪ The lower the barriers, the more likely that the poor will be able to participate as entrepreneurs and growth spread sectors and regions, leading to higher pro-poor growth</li> </ul>
<p><b>Predictable Rules of Exchange</b></p> <ul style="list-style-type: none"> <li>▪ Transparent decision making</li> <li>▪ Enforcement of contract</li> <li>▪ Transferable property rights</li> <li>▪ Level playing field with the public sector and larger businesses</li> </ul>	<ul style="list-style-type: none"> <li>▪ Transparent decision making, security of contract and the use of property and fair competition lower risk and provide incentive for entrepreneurship and investment</li> <li>▪ Higher risk is likely to limit growth to a few sectors and regions that offer potentially high returns making growth less pro-poor</li> </ul>
<p><b>Macro stability</b></p> <ul style="list-style-type: none"> <li>▪ Political and social stability</li> <li>▪ Monetary &amp; fiscal discipline</li> <li>▪ Wider tax base</li> <li>▪ Redirecting public expenditure towards basic services for the poor and increasing the productivity of investment in them</li> </ul>	<ul style="list-style-type: none"> <li>▪ Macro stability reduces risk, monetary and financial discipline frees resources for investment by the private sector and a wider tax base reduces the burden of taxation on business, contributing to higher rates of entrepreneurship and investment and broader based growth</li> <li>▪ It also reduces the risk of economic recessions that often reduce the incomes of the poor more than average incomes</li> <li>▪ Stability and greater access to capital encourage long term investment in fixed assets, increasing job creation and hence the rate of pro-poor growth</li> <li>▪ Investment in basic services enables the poor to participate in and benefit from growth</li> </ul>
<p><b>Governance</b></p> <ul style="list-style-type: none"> <li>▪ Law and order</li> <li>▪ Access to justice</li> <li>▪ Protection of human rights</li> <li>▪ Lower corruption</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lower risk to property and the person, security of personal freedoms encouraging entrepreneurship and investment</li> <li>▪ Poor are particularly disadvantaged by governance failures as the rich are better placed to circumvent them</li> </ul>
<p><b>Factor markets</b></p> <ul style="list-style-type: none"> <li>▪ Financial sector deepening</li> <li>▪ Flexible labour markets with growing demand for labour</li> <li>▪ Secure access to natural resources on a sustainable basis</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ease of access to factors of production facilitates entrepreneurship and investment</li> <li>▪ Financial sector deepening, increased rates of job creation in the formal sector and secure and sustainable access to natural resources increase the rate of pro-poor growth</li> </ul>



**c) What are the main challenges in providing incentives for entrepreneurship and investment that will contribute to pro-poor growth?**

Over the past two decades, substantial progress has been made in bringing about macro stability across the developing countries. However, fiscal and monetary discipline, a wider tax base and, in particular, redirecting government expenditure towards providing basic social services of health, education and infrastructure for the poor, remain elusive for some governments. Progress in improving governance has been far less impressive and it remains a major challenge to overcome the vested interest of those who benefit from poor governance in order to bring about change.

The role that reducing the cost of doing business plays in increasing the incentive for entrepreneurship and investment has been recognised for some time but there are wide variations in the ability of governments to deliver improvements. Hence, in Australia, it takes just 2 days to register a business as against the 203 days it may take in Haiti. The cost of enforcing a contract represents 0.3% of per capita income in Jordan as against 120% in Madagascar.<sup>35</sup> The need to co-ordinate the activities of numerous agencies of government, improve access to justice and overcome resistance to change from the bureaucracy are the barriers to progress.

*Private credit increases incomes of the poor and contributes to lower infant mortality*

Evidence shows that the process of financial deepening, whereby a country's financial sector increases the proportion of its assets used for investment by the private sector, is closely linked to its rate of growth and is the cause of higher rates of pro-poor growth.<sup>36</sup> In developed and rapidly developing countries, credit to the private sector represents close to 100% of GDP. In the low-growth economies of Africa, the rate is under 10%. Strikingly, cross-country evidence suggests that, between 1960-99, had Brazil had the same level of financial deepening as Korea, the incomes of the poor, instead of remaining stagnant, would have increased by 2% p.a., the same rate as average incomes.<sup>37</sup> Accelerating progress on financial deepening is a major challenge.

Inappropriate institutions that reduce the incentive for entrepreneurship and investment may drive the poor into the informal economy. In Africa, as much as 78% of non-agricultural employment is estimated to be in the informal sector and the rates for South Asia and Latin America are not far behind.<sup>38</sup> Informality increases with the number of procedures to start a business,<sup>39</sup> poor governance, discrimination against women and ethnic minorities, insecure property rights, a high tax burden and high costs of employment. They represent barriers to entrepreneurship and investment and so reduce the opportunities that the poor have to benefit from growth as entrepreneurs and workers.

*Informality is associated with low rates of pro-poor growth*

In the informal sector, the poor are more likely to experience poverty. Informal workers are unlikely to be able to exercise their rights, their jobs are likely to be less secure and they are likely to receive lower wages than their formal sector counterparts. It is in the informal sector that the highest incidence of child labour is to be found. Addressing informality is, however, a major challenge, calling for further research. The distinction between formality and informality is not clear cut,<sup>40</sup> there are many types of business in the informal sector and for many the informal sector is the only means of survival. Some of the poor, such as women with families, prefer

<sup>35</sup> Doing Business in 2004, Michael Klein, World Bank 2004.

<sup>36</sup> Finance, Inequality and Poverty: Cross Country Evidence, Beck T., Demircuc-Kunt A., and Levine R. 2004

<sup>37</sup> Beck T., Demircuc-Kunt A., and Levine R. 2004

<sup>38</sup> Becker, Kristina Flodman. The Informal Economy in Developing Countries: a Fact Finding Study.

<sup>39</sup> Klein M., The Cost of Doing Business, 2004, World Bank

<sup>40</sup> Rethinking the Informal Economy: Linkages with the Formal Economy and the Regulatory Environment, Chen M. EGDI and UNU-WIDER Conference, 2004.

to work informally. They are likely to remain informal and need assistance in coping with risk and vulnerability, through policies described below.

## II Increasing Productivity: Competition & Innovation

Though high rates of investment are necessary, they are not a sufficient condition to ensure high rates of pro-poor growth. In the former communist countries of Europe, despite investing in excess of 30% of GDP, growth was slow and ultimately unsustainable.<sup>41</sup> Growth is likely to be faster, more sustained and more pro-poor if additional investment is accompanied by growing productivity so that returns to investment increase, making available additional resources for future investment: a virtuous circle for growth.<sup>42</sup> Growing productivity should allow greater rewards for labour, benefiting the poor as workers, and, if the productivity of the poor increases, their incomes as entrepreneurs and farmers should also rise, contributing to pro-poor growth.

*Economies such as the US with low (20%) GDI/GDP ratios may still achieve rapid growth through productivity*

### a) How does productivity increase?

There are two main drivers of the growth of productivity:

- Increasing the efficiency with which factors of production are combined to produce goods and services through the use of better technology. Economists call this technical, static or productive efficiency, and it is driven by innovation. It is a major contributor to the growth of rich countries, such as the US, and has contributed to the rapid development of East Asian countries; and
- Shifting resources from activities with low productivity to more productive areas. Economists call these gains in allocative or dynamic efficiency, and many of the rapidly growing Asian economies have benefited from this.

Entrepreneurship is not just about more people doing the same thing. It is also intimately connected with what Schumpeter described as *new combinations or innovations*.<sup>43</sup> It is these new combinations that result in higher value addition and hence growth, through introducing new or better products and more efficient production methods to drive up productivity. The process of the development of the private sector is likened by him to *creative destruction*.<sup>44</sup> Those unable to compete with the innovators are driven out of the market, giving way to the more innovative and efficient. This requires that there are low barriers to entry and exit and that there is a hard budget constraint, so that governments do not keep on bailing out the inefficient. Without the pressure of competition, the need to innovate is diminished.

*PSD is a process of innovation and creative destruction*

Knowledge of how to combine factors of production to produce goods and services efficiently has been considered by many to be the fourth factor of production.<sup>45</sup> Such knowledge covers not only technology but also the ability to manage businesses. Access to knowledge impacts the rate of pro-poor growth. If it is confined to parts of the private sector or excludes the poor, growth is likely to be confined to a few sectors and the poor will benefit less as workers and farmers and entrepreneurs.

*Access to knowledge affects the rate of pro-poor growth*

<sup>41</sup> Ways Out of Poverty: Diffusing Best Practices & Creating Capabilities, Michael Klein, 2003

<sup>42</sup> See for Instance, IMF Working Paper 'And Schumpeter Said: This is How Shalt Grow, The Further Quest for Economic Growth in Poor Countries. Philippe Beaugrand, 2004

<sup>43</sup> Schumpeter J. 1911, Theory of Economic Development, p66.

<sup>44</sup> Schumpeter. Capitalism, Socialism and Democracy (New York: Harper, 1975), pp.82-85.

<sup>45</sup> Some observers refer to entrepreneurship as the 4<sup>th</sup> factor but they are referring to the use of knowledge or skills in combining factors of production.

With globalisation and the information, communications technology (ICT) revolution, the conditions for diffusing knowledge have never been better. But the pace of innovation does not depend upon knowledge alone. It depends also upon the business relationships and structures that enable the adoption of new technology.

The development of business networks, in the form of horizontal and vertical clusters and the strengthening of business organisations, have an important role to play in innovation and increasing productivity. Horizontal clusters, of the type found in Italy, and vertical clusters, such as those comprising Japanese multinationals and their SME suppliers, help to share knowledge, enable specialisation and flexibility in meeting customer needs through co-operation, and combine the advantages of scale in marketing and assembly that linking a group of SMEs provides.<sup>46</sup>

Such linkages are based on trust and so it is difficult to establish clusters where they do not exist organically. With or without clusters, for linkages between firms to increase, it is important that the costs and risk of doing business with other firms is kept low in relation to costs within the firm.<sup>47</sup> Developed economies are characterised by higher levels of transactions between firms that allow greater productivity through specialisation. They are able to achieve this through security of contract and lower cost of doing business with each other.

***Business networks help to spread knowledge and boost productivity***

For productivity to increase, resources should also flow to the most productive use. This may involve resources shifting to higher value-added products and services within a sector or, in broad terms, from agriculture to industry and services, which tend to have higher levels of productivity than agriculture. For resources to move to more productive uses, the role of regulatory institutions is critical to ensure that there is adequate access to information, that markets work efficiently to provide appropriate price signals and there is flexibility in the use of productive resources. They must ensure that markets protect the providers of capital, labour and natural resources whilst allowing them to move to more productive activities.

For higher rates of pro-poor growth, it is important that the poor have the opportunity to increase the productivity of their assets in traditional sectors and the ability to re-deploy their assets to more productive uses when they emerge. This depends upon the pattern of growth. Increasing agricultural productivity, non-farm employment and incomes in rural areas and formal sector employment in manufacturing and services are important determinants of the rate of pro-poor growth. The poor are provided with a greater diversity of sources of livelihoods. Countries such as Zambia and Nigeria, where formal sector employment in manufacturing has increased slowly with growth, have experienced low rates of poverty reduction, whereas Cote d'Ivoire is an example of a country where formal employment increased relatively faster with growth and there poverty has fallen significantly.<sup>48</sup>

***Greater formal sector employment offers opportunities for poor households to diversify and increase their incomes***

To maximise its impact on poverty reduction, growth of productivity in manufacturing and services should be accompanied by increasing agricultural productivity. The wages paid to attract labour away will need to be higher if productivity and incomes are increasing in their traditional livelihoods such as agriculture. In this way, the incomes of the poor rise in their traditional occupations and they have the opportunity also to earn incomes from employment in other sectors enabling them to adopt strategies that will maximise household incomes. Migration to urban centres

<sup>46</sup> Snodgrass D. & Winkler J., Enterprise Growth Initiatives, Where are they Going, DAI, 2003. This argument applies also to service industries where the practice of out-sourcing is gaining ground leading to new types of cluster.

<sup>47</sup> Coase, R The Nature of the Firm, *Economica* 4, 1937, explores the effect of inter and intra firm transaction costs

<sup>48</sup> Islam R. The Nexus of Economic Growth, Employment & Poverty: An Empirical Analysis, 2004.

may be such a strategy, helping to increase household incomes even when the wages received are low, as it adds a new source of income. Remittances are important for pro-poor growth.

Policies that address the access of the poor to knowledge and productive resources are important for increasing the productivity of the poor. Investment in their human capital allows them to increase productivity in current livelihood activities and to participate in new, more productive sectors of activity when they emerge.

The institutions and policies that affect productivity are set out in Box 3.

**Box 3**

Institutions & Policies for Productivity	Effect on Pro-poor Outcomes
<p><b>Factor markets</b></p> <ul style="list-style-type: none"> <li>▪ Financial sector deepening</li> <li>▪ Flexible labour markets with growing demand for labour</li> <li>▪ Investment in the human capital of the poor</li> <li>▪ Secure access to natural</li> </ul>	<ul style="list-style-type: none"> <li>▪ Enables investment to raise productivity across sectors contributing to pro-poor growth</li> <li>▪ Greater formal employment, along with rising productivity in sector traditional livelihoods, provides higher wages and diversity of opportunities to earn livelihoods</li> <li>▪ Sustainable natural resource use increases the productivity of natural resources, including those used by the poor</li> </ul>
<p><b>Business services, structures &amp; Networks</b></p> <ul style="list-style-type: none"> <li>▪ Disseminating Knowledge</li> <li>▪ Business services</li> <li>▪ Business Linkages</li> <li>▪ Clusters</li> <li>▪ Business Organisations</li> </ul>	<ul style="list-style-type: none"> <li>▪ Spreads knowledge of how to improve productivity across the private sector, including the poor</li> <li>▪ Business linkages facilitate innovation, raise productivity through specialisation and flexibility in meeting customer needs and enable economies of scale</li> </ul>
<p><b>Research &amp; Technology Organisations, Academia</b></p> <ul style="list-style-type: none"> <li>▪ Agricultural research &amp; extension</li> <li>▪ Scientific research</li> <li>▪ Innovation support</li> </ul>	<ul style="list-style-type: none"> <li>▪ Partnership between private and public sectors in adapting technology and innovation to meet local needs and help to spread knowledge. Technical support for innovation can improve access to knowledge, including to the poor</li> </ul>

### b) What role do SMEs play in increasing productivity?

In the past, there has been an assumption that SMEs help to increase growth and help to make growth pro-poor. Recent research casts doubt on the universal validity of these assumptions.<sup>49</sup> Micro-level evidence has for some time questioned whether SMEs are, in fact, more innovative or productive than their larger counterparts and better at job creation. SMEs tend to pay lower wages and the jobs they create are less secure. In fact, the proportion of the workforce employed in large firms increases with the level of development of the economy.<sup>50</sup> Cross-country evidence shows that, whilst a higher proportion of SMEs in the economy is associated with higher growth, it does not cause higher growth or necessarily lead to pro-poor growth.<sup>51</sup>

This is not to say that SMEs do not have a role to play in increasing pro-poor growth. What this evidence suggests is that it is outcomes in markets that matter to the poor that are important for pro-poor growth, not the size of business. Provided growth results in opportunities for the poor to improve their incomes, through higher wages in large enterprises for instance, then it will be more pro-poor. Support for the

<sup>49</sup> Small & Medium Enterprises, Growth & Poverty, Beck T, Demirguc-Kunt A and Levine R, 2003.

<sup>50</sup> Snodgrass & Biggs, 1996.

<sup>51</sup> Beck T, Demirguc-Kunt A and Levine R, 2003.

development of SMEs may be appropriate in instances where the comparative advantage of the country lies in sectors with low economies of scale, to support productivity gains through business linkages, and where there is a need to increase competition in selected markets that matter for the poor, as described in Chapter III. If the playing field is not level for SMEs, it will hinder entrepreneurship and investment and the forces of creative destruction and so lead to lower pro-poor growth. What is questioned by these findings is the assumption that support for SMEs is necessarily the most pro-poor form of support for private sector development.

### **III Harnessing International Economic Linkages**

#### **a) How do international economic linkages affect the rate of pro-poor growth ?**

As recognised in the DAC Poverty Guidelines, international economic linkages of trade and foreign investment could help to accelerate pro-poor growth. There is substantial evidence to suggest that greater trade integration, as measured by the ratio of exports and imports to GDP, is associated with higher rates of economic growth.<sup>52</sup> As international trade has been growing faster than domestic demand in many countries, the countries that have become integrated into the international trading system have experienced high rates of growth. International trade should help economies to move to the production of goods and services in which they have a comparative advantage and increase competition for domestic businesses, resulting in higher productivity. Exporters tend also to have higher productivity in order to compete internationally. High levels of trade protection cause higher domestic prices, and this impacts the poor adversely.

However, harnessing the potential benefits from increased international trade requires more than the reduction of tariff barriers. Without the right conditions in place, tariff reduction may not increase the volume of trade appreciably, contribute little to growth and may disadvantage the poor. Despite tariff reductions in most developing countries, a group of the least developed countries have failed to increase their share in international trade.

For countries to achieve higher levels of trade integration, tariff reduction needs to be accompanied by the dismantling of non-tariff barriers, trade should be facilitated by better trade facilitating and promoting institutions, investment in infrastructure and macro policies that result in a competitive exchange rate. To accelerate growth, productive resources should flow to sectors in which the country has comparative advantage, compensating for the contraction of other sectors and exports should include a wide range of commodities, reducing the dependence on commodities that are subject to sharp fluctuations in price.

The framework of the WTO Agreement recognises that developing countries may need “differential treatment”, in order to allow them to reinforce or transform their production capacity before being exposed fully to liberalized international trade. To make the effects of greater trade integration pro-poor, these countries may need to address the inequality in opportunity that the poor face in participating and benefiting from international trade. Institutions and policies that address the access of the poor to knowledge, infrastructure and productive resources are important. Inevitably, greater trade integration will result in winners and losers. For the poor who stand to lose from trade integration, policies to help them to adopt new

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<sup>52</sup> For a discussion of how and when trade may contribute to growth and poverty reduction see Sida Trade Briefs, Trade & Poverty, Constantine Michalopoulos, 2004

livelihood strategies and provide safety nets of the type described under Risk and Vulnerability below, may be necessary.

Foreign direct investment (FDI) is an important source of capital, several times the value of development assistance on a cumulative basis,<sup>53</sup> though the least developed countries have yet to attract sizeable flows of FDI. But perhaps the greater contribution of FDI is through innovation and productivity. In most countries, the vast majority of investment is domestic.<sup>54</sup> FDI's main contribution may come from the transfer of knowledge and skills. In Bangladesh, for instance, the rapid expansion of the garment industry, estimated to have taken one million women and their dependents out of poverty, was frequently undertaken by the former managers of foreign joint ventures<sup>55</sup> who learned their skills from foreign counterparts. For 40 years, the Indian automobile industry, protected from competition, produced the same models of car! The opening up of the industry to FDI revolutionised, within a decade, an industry fossilised for four. The much lower ability to attract FDI to India is believed to be a contributor to its lower growth in productivity compared with China.<sup>56</sup>

*FDI contributes to local investment and productivity*

The contribution that FDI will make to growth is likely to be higher if the knowledge of better technology it brings can be spread to domestic businesses through business linkages. Its impact on the rate of pro-poor growth will be higher if these businesses purchase goods and services produced by the poor and create jobs for the poor.

#### Box 4

Institutions & Policies for International Economic Linkages	Effect on Pro-Poor Outcomes
<p><b>Trade Openness</b></p> <ul style="list-style-type: none"> <li>▪ Tariff &amp; Non tariff policy</li> <li>▪ Trade facilitation</li> <li>▪ Domestic &amp; trade infrastructure, improving access for the poor</li> <li>▪ Building domestic capability to trade &amp; compete, export diversification</li> <li>▪ Competitive exchange rates</li> <li>▪ Access to knowledge and productive resources, particularly for the poor</li> <li>▪ Policies to help the poor take advantage of new opportunities and to protect the vulnerable</li> </ul>	<ul style="list-style-type: none"> <li>▪ Openness to trade allows the country to focus on areas of comparative advantage, contributing to sustained growth</li> <li>▪ Domestic infrastructure directed at the poor enables them to participate in trade</li> <li>▪ Greater ability to compete will increase the impact of trade openness on growth and reduce reliance on volatile commodities</li> <li>▪ Flexible factor markets and access to productive resources provide opportunities for the poor to benefit from trade openness</li> <li>▪ Uncompetitive exchange rates will depress exports, including those produced by the poor</li> <li>▪ Reducing the dependency of the poor on volatile commodity markets, helping them move out of activities that are likely to lose from trade integration and helping them cope with the loss of income in traditional livelihoods will contribute to pro-poor growth</li> </ul>
<p><b>Foreign Investment</b></p> <ul style="list-style-type: none"> <li>▪ Conditions for entrepreneurship and investment</li> <li>▪ Few regulatory restrictions applied transparently</li> <li>▪ FDI facilitation, particularly in sectors likely to benefit the poor</li> <li>▪ Business linkages with domestic firms</li> <li>▪ Prudent borrowing from abroad</li> </ul>	<ul style="list-style-type: none"> <li>▪ Enabling investment by both domestic and foreign entrepreneurs, providing the opportunity to establish business linkages</li> <li>▪ Lower regulatory risk, increasing the attractiveness of investment</li> <li>▪ Attitudes to foreign investment are an indicator of likely risk of policy change and hence affect entrepreneurship and investment</li> <li>▪ Harnessing FDI to provide opportunities for the poor to supply goods and services and labour</li> <li>▪ Transfer of knowledge to domestic firms leading to higher productivity</li> <li>▪ Imprudent borrowing from abroad</li> </ul>

<sup>53</sup> See for instance, World Investment Report.

<sup>54</sup> Even in China, the world's largest recipient of FDI, it accounts for less than 30% of Gross Domestic Investment.

<sup>55</sup> Unleashing Entrepreneurship: Making Business Work for the Poor. A report to the Secretary General, UN, 2004

<sup>56</sup> McKinsey, India: The Growth Imperative, August 2001.

**b) What are the main challenges in ensuring that international economic linkages are harnessed to accelerate pro-poor growth?**

Up to now, trade policies have focused on tariff reduction. Attention is only now shifting to the institutions and policies that are required if tariff reduction is to lead to greater trade integration. There has been little attention paid to who wins and loses from greater trade integration and the policies and institutions that are required to ensure that the poor benefit from the opportunities and are helped to cope with the potential loss of income in traditional livelihoods.

There is a need also to influence the evolution of the international trading system to increase its pro-poor impact. Tariff peaks and escalation that may impede exports of processed products from developing countries, subsidies on agriculture and the proliferation of technical barriers to trade (TBTs) that already affect over 90% of trade in goods and represent substantial impediments to market access are on the WTO agenda. A pro-poor Doha Round has the potential to lift 144 million people out of poverty, a substantial contribution to achieving the income MDG.<sup>57</sup>

At present, FDI is concentrated in a few countries, with the top 10 recipients accounting for over three quarters of total flows to the developing countries. These countries frequently have in place the conditions for greater entrepreneurship and investment described earlier. They also tend to have fewer regulatory restrictions on FDI and apply regulations more transparently. Allowing for differences in size of country, it is these conditions, rather than tax concessions, that account for the differences in attracting FDI.<sup>58</sup> The least developing countries and others that have yet to benefit substantially from FDI need to improve their investment climate for both foreign and domestic investment. Foreign owned firms need to be made aware of and supported in increasing the impact of their operations on the poor as farmers, entrepreneurs and workers.

#### **IV Improving Market Access & Functioning**

- **How does market access and functioning affect the rate of pro-poor growth?**

Whilst providing incentive for entrepreneurship and investment, increasing productivity and harnessing international economic linkages will, with appropriate policies and institutions in place, deliver pro-poor growth, the benefits of growth may not reach all the poor or benefit the poor to the fullest extent. For the poor to benefit fully, the mechanisms through which they are able to take advantage of the opportunities to increase their incomes provided by growth have to work effectively. The critical mechanisms through which the poor participate in and benefit from growth are the markets for productive resources and goods and services the poor rely on for their livelihoods and their consumption needs.

Frequently, the poor are disadvantaged in the terms on which they access these markets leading to lower pro-poor growth. The poor should, at the least, participate in and benefit in these markets on equal terms with the rest of the private sector. Where this is not the case, practitioners need to identify and address the causes.

<sup>57</sup> World Bank Global Economic Prospects, 2003.

<sup>58</sup> A survey on the role of Taxation & Foreign Direct Investment in Southeast Europe, OECD, April 2003.

**b) What are the appropriate policies and institutions for the markets for productive resources to deliver higher pro-poor growth?**

Markets for the productive resources of capital, labour and natural resources are key mechanisms through which the poor may benefit from a pro-poor pattern of growth. They enable the poor to participate in and benefit from growth in two main ways:

- Directly, by improving access to financial, human and natural assets; and
- Indirectly, as a result of new opportunities being created for the poor to earn livelihoods as workers, entrepreneurs and farmers.

Improved access to financial, human and natural assets increases the incomes the poor earn from traditional livelihoods. The way that these markets help the poor take advantage of opportunities presented by growth indirectly explains why increased private credit is pro-poor even when access to credit remains low for the poor. It also explains why increases in non-farm activity in rural areas, in formal sector employment and in wages have such strong pro-poor impacts, even though the poor may earn most of their livelihood from agriculture. They provide the poor with the opportunity to diversify sources and hence maximise household income.

In practice, though, the markets for productive resources may not deepen or the poor may be disadvantaged in the terms on which they may participate in them, contributing to a low rate of pro-poor growth. The cause of these market outcomes not being pro-poor include inappropriate policies and institutions with respect to these markets and disadvantages the poor suffer from lack of access to basic social services. Practitioners need to examine the pace at which these markets are developing and the terms on which the poor are able to access them.

The critical determinants of the growth of private credit are: i) macroeconomic management, which affects savings, the balance sheets of banks and the extent of crowding out by government; ii) the effectiveness of the regulatory institutions, legal systems and contract enforcement; iii) informational and transactional infrastructure, including credit bureaus and inter-bank markets; and iv) the structure of the banking system in terms of ownership and concentration which affects competition and hence the incentive to innovate.<sup>59</sup> The most common causes of the failure of private credit to grow rapidly are poor regulatory supervision of the banking system, crowding out of the private sector by the public, governments imposing policies to direct the lending of the banks and a lack of competition in the banking system.

The pro-poor impact of financial deepening would be greatest if increased private credit resulted in better access to credit for the poor, thus enabling the poor to benefit both directly and indirectly. This requires the financial sector to improve its ability to assess and mitigate risk and reduce the cost of serving the poor with savings and loan products. As discussed in Chapter 4 below, there are examples of how the formal financial sector may use technology to achieve this and how micro-finance institutions, with low transaction costs and better information on the poor, are becoming integrated into the formal financial system.

A number of conditions need to be met if the labour market is to function efficiently for pro-poor growth: i) labour regulations should strike a balance between the rights of labour and employers in terms of wages and employment conditions; ii) investment in education and skills training is needed to increase labour productivity, redressing any initial inequality in access; and iii) there should be no discrimination

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<sup>59</sup> See, for instance, Financial Development, Growth & Poverty: How close are the links? Honohan P., 2003



with respect to labour market access by women and ethnic minorities. In addition, what matters is that the economically active are able to find work in the formal sector. Restrictive practices which result in high wages and good working conditions for a few employees but low economic participation for the rest should be avoided.

Access to agricultural land and other natural resources is crucial for the livelihoods of the poor, the majority of which live in rural areas. Title to land and security over its use and over other natural resources such as forests, rivers and marine and inland fisheries, contribute to entrepreneurship and investment.<sup>60</sup> Sustainable use of natural resources ensures their productivity does not decline. Policies and institutions need to combine security over the use of natural resources, sustainable use of resources and equitable access for the poor. Providing market-based incentives to reduce adverse environmental impacts and reward the conservation of natural assets, such as markets to trade carbon emissions, have an important role to play. In accessing and using natural assets, economic, social and environmental factors need to combine to ensure sustainable development. The need to take account of social factors means that policies and institutions to govern access to natural resources are likely to have to be tailored to the specific, local context.

### **c) How can policies and institutions help to deliver pro-poor outcomes in the markets for the goods and services the poor sell and consume?**

In Chapter 1, it was noted that as entrepreneurs and farmers, the poor stand to benefit from growth through increased demand for the goods and services they produce. As consumers, they stand to benefit from the greater availability of better-quality products at lower prices. Thus, access to and outcomes of markets that the poor rely on to sell goods and services and meet their consumption needs strongly influence the rate of pro-poor growth.

Markets are composed of value chains that stretch from producers to the final consumer. They may either be producer or consumer driven, depending on barriers to entry and the processes that create value. In consumer-driven supply chains, the balance of market power lies with the consumer. These tend to be commodity or undifferentiated markets with low barriers to entry in which producers receive a small share of the total value created in the market. Agricultural commodities such as coffee, tea and palm oil are examples. On the other hand, producer-driven value chains tend to be those in which products are differentiated by technology, design and/or natural attributes and with barriers to entry. In these markets, the balance of power tends to lie with the producer. Blue Mountain coffee, from Jamaica, is an example, as are many manufactured products and service markets. And of course, there are many value chains that fall between these extremes, where a particular process in the value chain exercises the greatest market power.

*Returns to the poor depend upon where market power lies in value chains*

Institutions have an important role to play in delivering higher returns to the poor. Even in commodity markets, it may be possible to differentiate products based on particular attributes. Thus organic production, its area of origin or its specialist flavour may help differentiate coffees. The development of rules of certification and the systems for their delivery have a vital role to play in this regard. If they are not accessible to the poor, only the rich will be able to benefit from product differentiation. The provision of information by facilitating and promoting institutions helps to ensure that the poor may make economic decisions on the basis of informed choice and that those they trade with are not able to exploit them through superior access to knowledge. High costs of doing business, caused by

<sup>60</sup> De Soto, H. *The Mystery of Capital: Why Capitalism in the Works in the West and Fails Elsewhere*, 2000.

inappropriate institutions and lack of access to basic social services, may also disadvantage the poor.

Infrastructure is a prime example of how access may be denied to the poor or returns to their assets reduced. A lack of power may prevent rural areas from processing their crops. The cost of transport from a rural area, served by poor roads, may make many activities uneconomic. Further, if linked markets are underdeveloped, then the poor may be denied access. For instance, if the leasing market does not extend to agricultural machinery, hire services for such equipment will be undeveloped and the poor will not be able to use them.

***Competition drives markets to serve the needs of the poor***

The critical determinant of market outcomes is the extent of competition across the functions of the value chain. The lower the competition, the higher the proportion of the total value added by the chain that particular function will be able to capture. So, if there are few processors but many producers of a commodity, processors will capture a higher proportion of the total value of the commodity. Increasing competition in key functions of the value chain, through supporting new entrants and SMEs, is a valuable policy instrument in making markets work better for the poor.

Markets work in social as well as economic and geographic space. Social exclusion, through discrimination on gender or ethnic grounds may reduce market access. Policies that address gender equity may be particularly pro-poor as, frequently, a higher proportion of women than men are poor and women spend a higher proportion of their incomes on food, health and education for their families. Investing in the human capital of women, through literacy and skill training, is particularly pro-poor. Very often, the poor rely on their social capital to provide security (bonding capital), access to complementary resources (bridging capital) and to higher levels of decision-making and economic power (linking capital).<sup>61</sup> However, there are numerous examples of markets in which one ethnic or social group predominates and where others are excluded. In the extreme, there may be conflict over market participation, which disrupts their functioning entirely. Increasing the use of social capital whilst ensuring that it is not used to shut out others from accessing markets can help improve access to and functioning of markets.

***Markets work in social space. Social networks may be a source of conflict that prevents access***

#### **d) What are the main issues for improving market access and functioning?**

Labour markets play a critical role in providing opportunities for the poor to participate in and benefit from growth. In many parts of the world, though, rates of job creation are inadequate, forcing many to seek employment in informal 'survival' businesses that provide low incomes for the poor and where they may not be able to exercise their rights. Finding the mix of policies and institutions that would ensure that there is incentive to increase employment in the formal sector whilst ensuring that the rights of workers to adequate wages and working conditions remains a major challenge for practitioners.

Development agencies have been addressing value chains for some time with the objective of promoting growth and exports. Whilst many have targeted the growth of small enterprises, these interventions have tended not to focus on the extent to which market outcomes are pro-poor. Bringing about pro-poor outcomes may require a combination of agricultural development, infrastructural change private sector development to increase the market power of the poor in the value chain, social interventions to empower the poor, and environmental sustainability. Such multi-disciplinary activities face organisational barriers within the development agencies that require new approaches to donor support, as discussed in Chapter 4.

<sup>61</sup> World Development Report, 2000/1 Attacking Poverty, World Bank.

The institutions and policies that affect market access and functioning are set out in Box 5.

**Box 5**

<b>Institutions &amp; Policies for Market Access and Functioning</b>	<b>Effects on Pro-Poor Outcomes</b>
<p><b>Capital Markets</b></p> <ul style="list-style-type: none"> <li>▪ Macro stability</li> <li>▪ Interest rate liberalization</li> <li>▪ Reducing government interference in the lending decisions of the banks</li> <li>▪ Financial codes &amp; standards</li> <li>▪ Corporate governance</li> <li>▪ Financial infrastructure</li> <li>▪ Competitive banking system</li> <li>▪ Increasing the integration of financial institutions serving the poor into the mainstream financial system</li> </ul>	<ul style="list-style-type: none"> <li>▪ The incentive to save and lend is increased, the risk of lending reduced and it becomes possible to lend to smaller enterprises. Competition drives the banking system to greater efficiency.</li> <li>▪ Financial deepening associated with higher private credit leads to higher pro-poor growth, particularly if access to finance is improved for the poor through mainstreaming financial institutions best placed to serve their needs.</li> </ul>
<p><b>Labour Markets</b></p> <ul style="list-style-type: none"> <li>▪ Core labour standards,</li> <li>▪ Health &amp; safety</li> <li>▪ Realistic minimum wages</li> <li>▪ Flexible labour markets</li> <li>▪ Information on opportunities</li> <li>▪ Education &amp; vocational training to reduce inequality for the poor</li> </ul>	<ul style="list-style-type: none"> <li>▪ Policies and institutions protect the rights of labour, encourage employment, provide information on jobs and skills to improve the match between demand and supply and enable labour to move its most productive use.</li> <li>▪ Investment in human capital, leads to a more productive work force for employers and higher wages and better working conditions for employees, including the poor</li> </ul>
<p><b>Natural Resource Markets</b></p> <ul style="list-style-type: none"> <li>▪ Secure rights of access</li> <li>▪ Equity for the poor in access</li> <li>▪ Sustainable natural resource use</li> </ul>	<ul style="list-style-type: none"> <li>▪ Security of access encourages investment in natural resources. Equity in access contributes to pro-poor growth</li> <li>▪ Sustainable natural resource use contributes to long term productivity</li> </ul>
<p><b>Correcting Market Failures</b></p> <ul style="list-style-type: none"> <li>▪ Monopolies and restrictive practices</li> <li>▪ Aligning private and public benefits</li> <li>▪ Private provision of public goods through public-private partnerships</li> <li>▪ Addressing inequality in access to information</li> <li>▪ Developing linked markets</li> </ul>	<ul style="list-style-type: none"> <li>▪ Level playing for the poor in terms of access to markets and information and protection from the abuse of monopoly power and restrictive practices.</li> <li>▪ Linked markets help the poor to use technology that they may otherwise not be able to use</li> </ul>
<p><b>Pro-poor value chains</b></p> <ul style="list-style-type: none"> <li>▪ Regulating &amp; promoting standards, quality</li> <li>▪ Certification to reach the poor</li> <li>▪ Competition to reduce the value captured by functions in the value chain</li> <li>▪ Providing linked services</li> </ul>	<ul style="list-style-type: none"> <li>▪ Institutions provide the incentive for value chains to increase value addition, including for the poor</li> <li>▪ Reducing market power in other functions in the value chain increases incomes of the poor.</li> </ul>
<p><b>Social Cohesion &amp; Sustainable development</b></p> <ul style="list-style-type: none"> <li>▪ Institutions for gender, ethnic discrimination</li> <li>▪ Mitigating conflict</li> <li>▪ Building bridging and linking capital without excluding others</li> <li>▪ Sustainable development</li> </ul>	<ul style="list-style-type: none"> <li>▪ Prevents conflict thus reducing risk, opens up market opportunities previously reserved for particular social groups, builds co-operation between groups in economic exchange and facilitates access to decision makers to influence policy</li> <li>▪ Economic development is accompanied by social cohesion and environmental management</li> </ul>

## V Risk and Vulnerability

Unless the risk aversion of the poor and their vulnerability to shocks, man-made and natural, are addressed, there is a danger that they will not be able to participate and benefit fully from growth. The poor may be caught in 'poverty traps' whereby lack of access to assets prevents them from escaping poverty. Where such poverty traps exist, a case may be made for policies that provide economic opportunity and increase access to assets. For those who cannot participate in productive activities, what have been termed 'smart transfers' may help reduce vulnerability.

### a) What factors help to reduce risk and vulnerability and help the poor escape the poverty trap?

As far as possible, it is important to reduce the incidence of man-made shocks, through sound political, social and economic management, as they tend to hurt the poor disproportionately. The currency and sovereign debt crises that affected East Asia, Russia and Latin America during the 1990s were caused by an absence of sound macro economic policies and hurt the poor disproportionately. Social and political conflict, of the type witnessed in the Congo, also hurt the poor disproportionately, and effective measures are required to mitigate such conflict.

Deprivation caused by man-made or natural shocks tends to have long-term consequences. In Ethiopia, there is evidence that four years after the last crisis, the poor are still coping with its consequences.<sup>62</sup> When crises occur, the poor may have to consume or sell productive assets such as seed and land, suffer the erosion of the productivity of their human capital through disease or hunger and witness their access and returns to natural assets eroded, establishing a poverty trap from which they take many years to escape. Losers from trade liberalisation amongst the poor may also find themselves caught in a trap witnessing their incomes falling but lacking the knowledge and access to resources to diversify their livelihoods. It is important to have policies in place that help the poor cope with these shocks and escape the poverty trap.

The ability of the poor to cope with shocks is affected by the level of development of markets for productive resources. For instance, financial deepening is correlated with lower rates of child labour and infant mortality, irrespective of levels of per capita GDP.<sup>63</sup> With some access to credit and a diversity of income sources, the poor do not have to resort to measures that undermine their ways out of poverty and can borrow to meet health care needs. Where these markets are under developed or the shock particularly severe, there is a strong case for helping the poor cope with the disaster in the form of food for work to build infrastructure that they may use, medical assistance, if required, and economic assistance to revive livelihoods.

In the absence of insurance and publicly provided safety nets, the poor have adapted their livelihood strategies to manage and cope with risk.<sup>64</sup> The problem is that such risk mitigation strategies may not allow them to maximise incomes. Producing drought resistant crops that may not provide the highest return is an example and continuing to produce some staples when land is better suited to livestock is another. The result will be lower contribution to growth by the poor and less pro-poor growth. Risk-coping strategies such as keeping livestock are also not efficient as the animal is likely to be sold when others are selling theirs, resulting in low prices.

<sup>62</sup> Dercon S., Growth & Shocks: Evidence from Rural Ethiopia. 2003.

<sup>63</sup> Dahejia R & Gatti R. Child Labour: The Role of Income Variability & Access to Credit in a Cross Section of Countries, 2002.

<sup>64</sup> Poverty Traps & Development: The Equity-Efficiency Trade-off Revisited, Dercon S., 2003.

Encouragement of the insurance industry to provide risk cover for the livelihood activities in which the poor are involved may improve risk management and coping strategies. For example, it is possible in some developing countries to get cover for drought, livestock and other agricultural related activities. Savings schemes that protect against risks to livelihoods also have a role to play.

Sickness and old age may debilitate and reduce the ability to participate in and benefit from growth. Effective health care may prevent and mitigate such vulnerability. However, for those living with diseases such as HIV/AIDS, the old and those with other chronic conditions, there may be a need to provide social safety nets, publicly funded if need be. The current thinking is that, as far as possible, such social protection should take the form of 'smart transfers' where the poor are assisted so long as they help themselves. Mexico's Progresa/Oportunidades and Brazil's Bolsa Escola/Bolsa Familia are examples of smart transfers for education and health.<sup>65</sup>

Even countries that are experiencing rapid growth and poverty reduction, such as China and Vietnam, may have regions that are caught in poverty traps. Essentially, the locational advantages of some regions result in growth being concentrated in them. The coastal regions of China, with access to ports, are examples. Though other regions may benefit from this growth through migration, they may not be able to reduce poverty. A frequent response is to offer tax incentives for the private sector to locate in the disadvantaged region. Often, this does not work, or if it does, serves mainly to divert rather than increase growth. What is required is for such measures to be accompanied by the reduction of risk and cost of doing business, knowledge transfer to improve productivity, investment in basic services and improved market access and functioning to ensure that productivity and incomes increase in the region, increasing the pro-poor impacts of migration.

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<sup>65</sup> World Development Report, World Bank, Making Services Work for the Poor, 2003/4.

Institutions and policies that address risk and vulnerability are set out in Box 6.

### Box 6

Institutions & Policies for Risk & Vulnerability	Effects on Pro-Poor Outcomes
<b>Macro Economic Stability</b> <ul style="list-style-type: none"> <li>▪ Prudent fiscal, monetary policies</li> <li>▪ Sound banking supervision</li> <li>▪ Low currency and sovereign risk</li> </ul>	<ul style="list-style-type: none"> <li>▪ Lower man made shocks that hurt the poor disproportionately</li> </ul>
<b>Markets for Productive Resources</b> <ul style="list-style-type: none"> <li>▪ Increased access to finance to support recovery from shocks</li> <li>▪ Greater opportunity for diversifying livelihoods</li> <li>▪ Greater access to natural resources</li> </ul>	<ul style="list-style-type: none"> <li>▪ Less recourse to distress sales of assets, use of child labour and destructive use of natural resources that undermine future livelihoods</li> </ul>
<b>Markets for risk insurance</b> <ul style="list-style-type: none"> <li>▪ Drought insurance</li> <li>▪ Livestock insurance</li> <li>▪ Savings instruments to mitigate risk</li> </ul>	<ul style="list-style-type: none"> <li>▪ Less risk aversion on the part of the poor leading to higher incomes</li> </ul>
<b>Social Safety Nets &amp; Smart Transfers</b> <ul style="list-style-type: none"> <li>▪ Food for work</li> <li>▪ Smart transfers for health &amp; Education</li> <li>▪ Livelihood support after shocks</li> <li>▪ Social insurance (disability, pensions)</li> </ul>	<ul style="list-style-type: none"> <li>▪ Greater participation by the poor in the growth process, better access to markets and quicker recovery after shocks</li> </ul>
<b>Investment in Disadvantaged Areas</b> <ul style="list-style-type: none"> <li>▪ Increasing the incentive for entrepreneurship and investment</li> <li>▪ Stimulating productivity growth</li> <li>▪ Efficient public expenditure on health, education, water, other infrastructure, particularly in areas in which the poor live</li> <li>▪ Area based programmes to improve market access and functioning</li> </ul>	<ul style="list-style-type: none"> <li>▪ Stimulating economic activity in the region, offering greater opportunity for the poor</li> <li>▪ Increased productivity of labour and accumulation of human capital that will help to increase growth and the incomes of the poor</li> <li>▪ Better access to markets for the poor</li> </ul>

### In Summary

The five factors described above form an environment that enables the private sector to deliver growth. The institutions and policies that help to bring them about also influence the pattern of growth, affecting the extent to which growth provides opportunities for the poor to increase their incomes. The factors are interlinked. If one is not in place, then it will slow down the rate of growth, or make the pattern of growth less pro-poor. Thus, if entrepreneurship and investment, productivity and the harnessing of international economic linkages are providing opportunities for the poor to increase their incomes, but the poor are not able to access markets or escape poverty traps, they will be less able to participate in and benefit from growth. Equally, the poor are unlikely to be able to escape the poverty trap if the conditions are not in place for entrepreneurship and investment across a wide range of sectors and regions. The development of markets for productive resources affects all five factors.

To bring about a pro-poor pattern of growth, policies and institutions need to ensure that there is a level playing field for all players in the private sector, including the poor. Policies that address the initial inequality that the poor suffer in participating in and benefiting from growth are vitally important if support for the private sector is to accelerate pro-poor growth.

## **Chapter 3: Delivering Pro-Poor Change**

*Chapter 2 addressed institutional and policy change to accelerate pro-poor growth. The critical issue is how to bring about the required changes, transforming markets in order to make the private sector deliver pro-poor outcomes and implementing policies that enable the poor to take advantage of the potential benefits of a growing economy. This chapter analyses the necessary processes for establishing institutions and policies to deliver pro-poor growth through PSD and suggests how such change may be institutionalised through PRSPs.*

To accelerate pro-poor growth through private sector development, we need to know not only what has to be done but also how to bring about change. In Douglas North's view, we have known for some time the conditions required for growth and poverty reduction, what we have not known is how to bring about such conditions.<sup>66</sup> All too often, technically sound proposals for change proposed by practitioners have not been implemented because they have lacked support or have been blocked by vested interests.

### **I. Processes for Pro-Poor Change**

Institutions and policies result from the interaction of the state, the private sector and civil society. Though government is the main actor in developing policies and institutions, the private sector and civil society also play key roles. Whilst the state plays the crucial role in determining the rules under which markets function and the terms on which the poor access markets, by developing formal institutions and providing infrastructure and access to basic social services, civil society and the private sector have an important influence. Civil society influences government in developing formal institutions. Informal institutions, arising out of culture and social interaction also determine the terms on which the poor access markets. So, informal saving and loan clubs may provide access to finance but traditional land use practices may deny access to women. The private sector influences the rules of the game too, both by interacting with the state in the design of formal institutions and in developing institutions itself. Market outcomes are influenced also by conventions that are developed by the private sector.

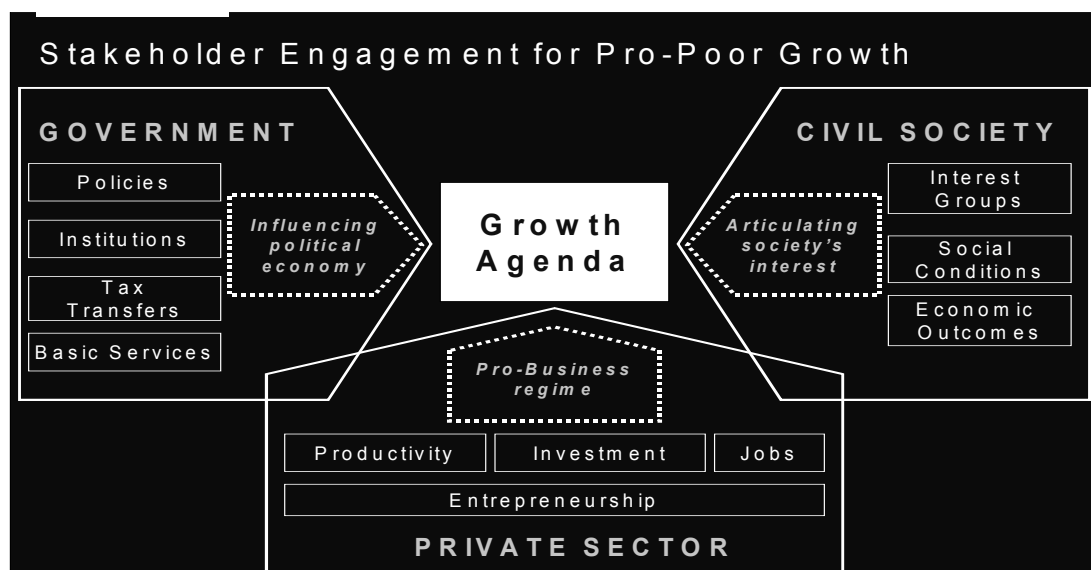
*Institutions and policies result from the state, the private sector and civil society pursuing their respective interests*

The three parts of society have different interests. In general, governments tend to be concerned with exercising influence over the political economy of growth: who gets what and how. The private sector focuses on how 'pro-business' institutions are and hence on the incentive for entrepreneurship and investment. Civil society's role is to articulate the interests of society and hence it is concerned with social and economic outcomes. Institutions and policies develop out of engagement between these three groups, with each pushing its own interest, with the respective strengths of each determining the mix of policies and institutions.

The extent to which the three parts of society take account of the interests of the poor varies markedly between countries. In practice, within parts of society, there are a diversity of organisations and interest groups promoting their own interests, and they may disagree with others on specific issues. Where interest groups, drawn from the elite combine to capture institutions and resources for their own self-interest, institutions are unlikely to be pro-poor. Each status quo represents an accommodation between the most influential interest groups, as illustrated in Figure 2.

<sup>66</sup> North D. Institutions, Institutional Change & Economic Performance.

Figure 2



For those seeking to bring about pro-poor change, it is important to initiate a dialogue within the three parts of society on the need for, and benefits from, pro-poor institutional and policy change. Even when where elites have captured institutions and resources, there are likely to be groups within each part of society that are sympathetic for the case for pro-poor change. Working with such groups, the case for pro-poor change, in terms of the pace and sustainability of growth and social cohesion, needs to be articulated. However, any change involving such important issues threatens the political settlement that is the status quo. Institutional and policy changes required to accelerate pro-poor growth involves issues of political economy that needs a careful politically sensitive mix of negotiation and contestation, otherwise the process risks being blocked by powerful interest groups.

In proposing change therefore it may be preferable to start with a specific, less challenging issue to build momentum for change. Even with such an issue, resistance to change from some groups will be inevitable. In many situations where the need for change is clear, the key barrier to pro-poor change is likely to be that the potential losers from that change use their power or influence to block change.<sup>67</sup> For instance, whilst parts of the private sector and civil society may agree that reducing restrictive business procedures is desirable, the bureaucrats and those who have already established businesses may oppose it as it will lose them influence or result in greater competition.

***Building and empowering constituencies for change may help overcome vested interest***

To overcome such resistance, it may be useful to help build and empower constituencies for change drawn from groups within each part of society. These constituencies may then engage with those opposed to change and the uncommitted to overcome resistance. For instance, it may be possible to build a constituency in favour of reducing business procedures from within government, especially those responsible for supporting small businesses, the representatives of small business and parts of civil society that support employment generation. The constituency may present evidence to demonstrate likely gains for entrepreneurship, investment, jobs and productivity and to make the change acceptable to bureaucrats, propose an increase in registration fees in exchange for fewer, more transparent procedures. Change may be facilitated by evidence-based dialogue, offering technical solutions to meet the concerns of those opposed to

<sup>67</sup> "What does Drivers of Change mean for DFID", (A draft approach paper). DFID: August 2003.



change, and, ultimately through negotiating compensation with the potential losers from change.

The process of bringing about issue specific change needs to begin with mapping stakeholders and their interests, capabilities and opportunities, and, if possible, what evidence or compensation is required to overcome the resistance to change. This could be followed by the building of the constituency for change by bringing together stakeholders and showing them how the change may help to deliver their diverse, desired outcomes. The constituency for change may then be provided with the range of alternative policies and institutions that may deliver the intended outcome, so that they become fully committed to an agreed course of action. The constituency may then be enabled to undertake a process of influencing policy makers and dialogue with those opposed to change.

An approach based on these principles is an explicit recognition that pro-poor growth through support for PSD involves not only economic and social change but is also inextricably linked with political economy. Knowing who gains and who loses is thus an essential part of delivering pro-poor change. This is increasingly becoming part of the way that donors are planning and implementing their assistance to their partner countries, as discussed in Chapter 4 below.

## II. Priorities & Sequencing Change

Is it possible to develop, on a priori grounds, a sequence of policy and institutional change for ensuring pro-poor growth? The answer is unfortunately no. The priorities can only be set in the local context by analysing the extent to which growth is pro-poor, as described in Chapter 1, that factors that constitute an enabling environment for PSD described in Chapter 2 are in place, that the patterns of growth resulting from them offers opportunities for the poor, that market outcomes in important markets are pro-poor, and the extent to which risk aversion and poverty traps exclude the poor. They depend also on taking account of current political settlements and the level of resistance to change, as described above.

*Local contexts determine priorities and the sequencing of change*

Diagnostic tools such as private sector assessments<sup>68</sup> and guides for economic analysis may be a useful starting point in this regard. A recently developed tool,<sup>69</sup> for instance, recommends analysing growth in geographic, sector, institutional and beneficiary (including gender) terms, helping to highlight how growth can be made pro-poor.

The conditions and measures described in Chapter 2 are not meant to be a full and prescriptive list of policies, nor are the factors described their meant to be absolutes. What matters most is how the private sector perceives opportunities, risks and constraints, not whether a country is better than its peers in absolute terms. So, in country A, a 5% rate of inflation will be considered to be sufficiently low to constitute stability and in country B the very epitome of a high-risk macro environment. A rate of tax that is considered acceptable in one country may be considered penal in another. Private sector development results from an implicit contract between the private sector, the state and civil society. The priorities for change depends on what the main stakeholders believe are undermining the contract or may help to improve it.

<sup>68</sup> These are used by the Asian Development Bank, for instance, to take stock of conditions for PSD.

<sup>69</sup> Economic Analysis Reference Guide, SNV, 2003.

Thus, recourse to tools such as the World Bank's investment climate assessments or UNCTAD's investment compass, is useful. They help to provide evidence in support of change and should be used as part of an engagement process to identify the key constraints in the local context as perceived by the principal actors. There are also various alternative institutional arrangements that may lead to the same outcome. So, independent targeting of inflation is possible with and without an independent central bank. What works depends on the views and attitudes of the key decision makers. It is important in developing institutions to consult the main stakeholders.<sup>70</sup>

*Engagement helps identify priorities and build consensus for change*

Growth may start from a variety of sources including location advantages, natural resource endowments, comparative advantages from factor endowment, the entrepreneurship and competitive advantages developed by the private sector, and institutional and policy change. There are many instances of short-lived growth spurts that have been sparked in these ways.<sup>71</sup> Even a comparatively small change in government's attitudes towards business may spark growth, as occurred in India during the 1980s.<sup>72</sup>

Turning growth spurts into sustained, pro-poor growth involves a continuous process of institutional and policy change to bring about a pro-poor pattern of growth. Whilst growth may be started by pro-business reform, for pro-poor growth, it must evolve into pro-market reforms, embracing the five factors described in Chapter 2 and policies that enable the poor to benefit from growth. With no set guidance on priorities and sequencing, experimentation with institutional change and monitoring outcomes is inevitable. Hence, the emphasis on stakeholder engagement above. Institutionalising such engagement is therefore important in developing conditions for pro-poor growth.

*Intended beneficiaries are best placed to monitor outcomes*

Effective monitoring of outcomes should involve participatory learning, so that the intended beneficiaries can feedback on how effective the change has been, and what should be done to improve the process to achieve better outcomes in the future. Pro-poor growth is about outcomes rather than outputs. Outcomes are best assessed by those impacted by change. Engaging the poor in determining the extent to which they have benefited from institutional change must be part of the institutionalising stakeholder engagement for accelerating pro-poor growth. Moreover, as conditions for pro-poor growth and outcomes are location specific, the need to engage local stakeholders so that participatory monitoring is carried out at local, sub-national levels is clear.

### III. Mainstreaming PSD in PRSPs

In view of the role of the private sector in delivering pro-poor growth and the crucial role that pro-poor growth plays in poverty reduction, private sector development must be mainstreamed in national development and poverty reduction strategies of the type that Poverty Reduction Strategy Papers (PRSPs) are meant to represent. PRSPs offer an opportunity also to institutionalise the type of stakeholder engagement and participatory planning, monitoring and evaluation described above. In fact, a recent study<sup>73</sup> shows that the private sector was consulted in PRSP formulation, though participation in the planning committee that drafted the PRSP, but its active involvement in monitoring and evaluation, and that of civil society, occurred only in a minority of cases.

<sup>70</sup> Rodrik D. Growth Strategies, 2003.

<sup>71</sup> Rodrik D., Growth Strategies, 2003.

<sup>72</sup> Rodrik, D. & Subramanian, A. (2004), "From "Hindu Growth" to Productivity Surge: The Mystery of the Indian Growth Transition" Cambridge: NBER Working Paper No. w10376: 2004.

<sup>73</sup> Poverty Reduction Strategy Papers: How Do They Treat The Private Sector, USAID, 2004.

That study showed that most PRSPs now acknowledge that the private sector is essential for poverty reduction, that growth and market forces are central to it, that policies for trade openness are important and that governance needs to be improved. What is less well addressed is specific changes to business regulations, specific benchmarks for the development of the private sector, market access and functioning. Thus, they acknowledge the role of the private sector without specific commitments as to how it will be enabled to deliver pro-poor growth. This is a shortcoming that must be addressed if PRSPs are to become strategies for poverty reduction through pro-poor growth.

*PRSPs can help institutionalise stakeholder engagement*

#### **IV. In Summary**

Bringing about pro-poor change requires a sound understanding of political economy. Institutional and policy change may threaten the current political settlement and so must involve a careful mix of contestation and negotiation. Bringing about change issue by issue appears to offer greater prospects for success than wholesale reform. To overcome resistance to change, mapping stakeholder interests, helping to build constituencies for change and empowering them to overcome vested interest through evidence based dialogue, technical solutions and negotiating compensation for losers, appears to be a fruitful approach. It is not possible, on a priori grounds to determine priorities and sequencing of change that can only be determined in the local context, using diagnostic tools and understanding stakeholder interests. Institutionalising engagement between the three parts of society, including participatory monitoring and evaluation by the intended beneficiaries appears to be the way forward to introduce a continuous process of changing institutions and policies, monitoring outcomes and then introducing further change. PRSPs offer a valuable mechanism for institutionalising such a continuous process.

## **Chapter 4. Donor Support in the New Private Sector Development Agenda**

*What has been described in the chapters above represents a broadening of the private sector development agenda. This chapter examines the implications of the new private sector development agenda for the way that donors provide support. It takes stock of how they provided support in the past, discusses the key principles for providing support in the future and assesses the organisational implications of the new, broader agenda.*

### **I. Donors in the New PSD Agenda**

Both governments and their donor partners have for some time now recognised the role of the private sector in bringing about growth as a necessary condition for poverty reduction. The DAC Orientations were one of many frameworks developed to support the private sector in its role as engine for growth. Donors supported governments to provide technical and financial support for the private sector, especially if it involved the poor, e.g. agribusiness and small enterprises. The paradigm for private sector development was that the poor relied on these businesses for their livelihoods, these businesses were disadvantaged and that justified subsidising their access to knowledge and finance.

The discussion above shows that the way the poor participate in and benefit from growth is more complex. It depends on a set of factors that provide an enabling environment for the private sector, including the poor, to generate rapid and sustained growth, help to increase opportunities for the poor to increase their incomes and empower the poor to take advantage of these opportunities. It highlights the importance of outcomes in a set of key markets that help to increase pro-poor growth and the role of institutions and policies in shaping those market outcomes. This broader private sector development agenda recognises that the poor benefit from growth both directly and indirectly, and hence is broader than the old agenda which focused mainly on targeting the livelihoods of the poor directly. It is based on the understanding that it is market outcomes that are pro-poor rather than the size of business.

### **II. Forms of Donor Intervention in the Past**

The majority of donor support for private sector development in the past was direct support to the private sector. For example, it is estimated that 80% of the World Bank's support for private sector development was direct to businesses.<sup>74</sup> Some of this took the form of supporting public-sector business support agencies that then supported businesses that met their criteria. Another popular intervention amongst donors was to encourage businesses in the donor's country to form joint ventures and other types of alliance with businesses in developing countries. Technical support, in the form of business development services to improve productivity and hence growth was provided through donor projects or using business organisations and other agencies, frequently with subsidies provided to users. In providing finance, the chosen mode was to provide funds and technical support for banks serving SMEs or micro finance organisations, often with subsidies to reduce the cost of borrowing. Many of these forms of intervention remain in practice today.

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<sup>74</sup> Small & Medium Enterprises, Growth & Poverty, Beck T, Demircug-Kunt A and Levine R, 2003.

The shortcomings of these forms of intervention were:

- They frequently distorted markets through attempting to "pick winners". The interventions may have helped ensure the success of entrepreneurs that should have failed through the process of creative destruction.
- Provision of services by public-sector agencies and donors crowded out private sector provision of these services and caused market distortions. Market deepening slowed down, disadvantaging micro and small businesses in the long run. Some suffered moral hazard with the lending organisation not overly concerned with how it lent someone else's money.
- In the end, the interventions were unsustainable. Governments ran out of money or developed other priorities and donors moved on to other projects and countries.

These shortcomings have resulted in new approaches being adopted progressively that stress the importance of establishing an enabling environment for private sector development, deepening markets and improving terms of access through institutions and policies, as described below.

Perhaps the most glaring deficiency was the neglect of institutional change. With inappropriate institutions leading to unfavourable conditions for pro-poor growth, direct support was likely to be ineffective. When institutions started to get the attention they deserved, development agencies attempted to drive change through the technical merits of their intervention and even resorted to conditionality. For institutional change, the most common form of intervention was to use technical experts, provided by donors or local experts, to develop new regulations or strengthen regulatory or facilitating organisations. Inevitably, such initiatives ran into resistance from vested interest, including the private sector, which blocked change. It is now recognised<sup>75</sup> that change must be internally driven with development partners playing an enabling role.

### **III. The Role of Donors in Supporting Private Sector Development to Accelerate Pro-Poor Growth**

The new private sector development agenda and the recognition that the role of donors is an enabling one means that donors need to change their approach to providing support for private sector development with the aim of accelerating pro-poor growth. They need to support partner governments to measure the extent to which growth is pro-poor, helping with data collection and analysis. They need to support them in analysing the extent to which the five factors that contribute to an enabling environment for private sector development are in place and highlight institutional and policy weaknesses that may cause growth to be less pro-poor. They may provide the analytical support required to use diagnostic tools that reveal weaknesses in these conditions through examining patterns of growth and the ability of the poor to participate in and benefit from growth. Perhaps most importantly, they need to support the process of stakeholder engagement that leads to pro-poor institutional change. They may use their influence and resources to help institutionalise the process, using PRSPs or other mechanisms, and ensure that participatory monitoring and evaluation forms part of the process. The priorities for donor support should emerge from their facilitation of the process of stakeholder engagement.

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<sup>75</sup> Stiglitz, New Development Paradigm.

#### IV. Bringing About Systemic Change

The new paradigm that is emerging to provide support for private sector development is based on the concept of systemic change, changing the incentives within markets to deliver pro-poor outcomes rather than providing direct support to enterprises. Systemic change usually involves a combination of:

- Institutional change: Changing the way market regulating, facilitating and promoting organisations work (formal and informal) to provide rules of the game that facilitate and promote pro-poor outcomes; and
- Improving access and catalysing the deepening of markets by supporting enterprises through developing linked markets for goods and services they require.

To illustrate the approach, business development service (BDS) and access to finance, two major areas for direct donor support in the past, serve as useful examples. In the past, donor projects provided services to help small enterprises survive and grow as an end in itself, the cost justified by increased output and jobs. It is now recognised<sup>76</sup> that high-impact BDS interventions target particular outcomes in markets, e.g. in value chains and sub-sectors to increase the incomes of the poor, contributing to regional development, helping target beneficiaries such as women and improving market access for the poor. For example, the BRAC program in Bangladesh has improved the value chain for poultry by selective interventions to improve functions such as hatcheries, chick rearing and feed, resulting in higher value addition and job creation for thousands of poultry farmers.<sup>77</sup> The programme does not work exclusively with small enterprises, supporting the growth of large hatcheries. This is a recognition that it is not the size of enterprise that is pro-poor but market outcomes. And, there are many other examples of such BDS interventions.<sup>78</sup>

**Market outcomes are pro-poor, not necessarily the size of business**

Other ways in which the new approach to BDS differs from the past are:

- It is recognised that the absence of fee for service providers does not mean that the services businesses need are not being provided. Embedded services provided by large enterprises may also play this role and these may be supported by providing market based incentives; and
- A market based approach to BDS aims to deepen service markets by critically examining institutional constraints and demand and supply side problems to ensure that the intervention will address specific constraints and not distort the market. Thus, if trust is a problem, the solution may be to develop a system of training and accreditation of BDS providers.

**“To achieve its full potential, micro finance must become a fully integrated part of a developing country’s mainstream financial system”  
Elizabeth Littlefield,  
CGAP**

The principles of introducing systemic change are illustrated by the new approach to providing access to finance. In the past, donors provided finance for the poor through specialist micro-finance organisations. Subsidising the cost of borrowing was justified by helping the poor out of a poverty trap. The result was that the micro-finance organisations remained separate from the rest of the financial system, dependent on continued donor support and their separate existence possibly reduced the incentive for financial deepening to reach the poor. Only a few of the lucky poor benefited.

The new approach to access to finance recognises that what is required is systemic change that leads to financial sector deepening, which progressively increases the

<sup>76</sup> Developing Commercial Markets for BDS. Primer, ILO. 2003.

<sup>77</sup> Newnham J. The BRAC Poultry Programme in Bangladesh, www.sedonors.org.

<sup>78</sup> BDS. Primer, ILO. 2003.

availability and credit to the private sector and the poor. The institutions and policies described in Chapter 2 to improve private credit of macro economic policies, effective governance over the private sector and strengthening competition are therefore as much a part of the new agenda for improving access to finance for the poor as is micro finance. The evidence suggests that private credit is a causal factor in pro-poor growth.

To accelerate the access of the poor to finance, micro finance has a vital role to play. But for it to do so as part of financial deepening, it must become part of the mainstream financial system and is, in fact, potentially the most high risk, high reward part of it. To achieve this objective, the approach:

- Works with micro-finance providers to help them work on a commercial basis;
- Supports commercial banks who enter the market for micro finance either on their own or by developing alliances with micro finance organisations;
- Develops financial infrastructure and institutions required to integrate the micro finance organisations, including credit bureaus, credit rating agents and accreditation systems and wholesale finance markets; and
- Works with both micro finance organisations and commercial banks to introduce technology that enables transaction costs to fall and increases coverage into rural areas.

Mainstreaming micro finance will reinforce systemic change within the financial sector providing incentive for the commercial banks to lend to the poor. Like the approach to BDS, the new approach to micro finance works with the market, using commercial rationale to introduce change.

## **V. Change the system without becoming part of the system**

In delivering such change, donors can either intervene directly or use change agents and facilitators. The problem with the former is that it makes the intervention part of the system. That may alter the system for a time but make progress dependent on continued or further intervention. This is unlikely to be sustainable.

To bring about institutional change, what is required is to support change agents in the process of engagement and dialogue. Change agents are likely to be influential and knowledgeable individuals or organisations with an interest in bringing about pro-poor change, but who command the respect of those opposed to change. They can help to build constituencies for change and facilitate the initial engagement process. Donors may sponsor and empower existing change agents or foster the emergence of new agents. The evidence to support the case for change and, if required, technical support, can be provided through them to stakeholders. Donors may influence and enable them to help institutionalise the process of engagement, monitoring and evaluation. This should ensure sustained progress on reform.

## **VI. Implications for Donor Organisation**

In the past, private sector development support formed a component of donors' country assistance strategies or programmes, separate from economic and governance reform, sector wide approaches (SWAPs) and assistance targeting the livelihoods and risk and vulnerability of the poor. The new private sector development agenda requires that pro-poor growth through support for private sector development should form a major strand, if not the centre, of country assistance strategies or plans, bringing together the strands of economic and governance reform, support for private sector development and livelihoods and risk and vulnerability. The strategy should itself be derived from the process of

stakeholder engagement that the donor is supporting, or at least have stakeholder buy in.

Internally, private sector development was considered one of a number of separate tools that the donor could deploy in support of poverty reduction. The new private sector development agenda suggests that pro-poor growth through private sector development is a crosscutting issue that should help to inform and guide much of the work of donors. Organisationally, support for private sector development was frequently a separate department staffed with skills in enterprise development and finance for small enterprises. Accelerating pro-poor growth through private sector development requires bringing together a wider range of skills. Its place in the organisational structure should enable it to support the work of country-facing departments and to co-ordinate the work of a number sector or skill departments. It should therefore be placed in a position within the organisational structure in a place similar to a policy department.

In the past, donors have provided assistance through projects and evaluated them in terms of inputs and outputs. The new private sector development agenda calls for programmatic assistance, a series of specific interventions that are co-ordinated under the umbrella of a programme. One-off assistance is unlikely to be able to capture the range of assistance required to bring about desired outcomes across the range of conditions required for pro-poor growth. Moreover, as progress on interventions such as bringing about institutional change through stakeholder engagement cannot be predicted with precise accuracy, it is important to build in flexibility in the delivery of assistance. Programmes allow such flexibility. Monitoring and evaluation should focus on outcomes not outputs and include participatory evaluation and learning.

Externally, the new private sector development agenda presents a useful framework for donor co-ordination. Given the breadth of the agenda, it is unlikely that any single donor could take on the whole agenda on its own. This paper provides a common framework for analysis to ensure that all contributing factors for pro-poor growth are being addressed. SWAPs may be a useful mechanism for such donor co-ordination but to accelerate pro-poor growth through support for private sector development, SWAPs should involve not only government but also the private sector and civil society groups that represent the interests of the poor.

## **VII. In Summary**

The new private sector development agenda is broader than the old agenda that focused on supporting particular types of business e.g. small businesses or agribusiness. It aims to bring about favourable conditions for pro-poor growth through institutional and policy change and recognises that it is market outcomes that may be more or less pro-poor, not type of business. It aims to bring about systemic change that alters the incentive for the private sector to help make it deliver pro-poor outcomes. In bringing about systemic change, donors should aim to change the system without becoming part of the system. Institutionalising systems of stakeholder engagement, including participatory monitoring and evaluation, should put in place processes for local stakeholders to bring about systemic change. Within donor organisations, accelerating pro-poor growth through support for private sector development should form the core of country strategies and plans and be regarded as a policy function to support all country-facing departments. The function needs to have a broader set of skills than enterprise development. Externally, it requires effective donor co-ordination, perhaps through SWAPs that also involve the private sector and civil society.



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