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Pro-Poor Growth & Private Sector Development

Concept Note

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The attached draft has been prepared by a consultant (Mr. Sunhil Sinha) with DFID support to provide conceptual background on the contribution of the private sector to pro-poor growth. It is circulated to POVNET as background to its discussion on the private sector development theme.

The note is a working draft that has not yet been reviewed by the private sector development task team (which will meet on 29 March 2004 to discuss the draft and prepare for the POVNET discussion).

Contact Person: Ebba Dohlman - Tel: +33 (0) 1 45 24 98 48 - Email: ebba.dohlman@oecd.org

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PRO-POOR GROWTH
&
PRIVATE SECTOR DEVELOPMENT

CONCEPT NOTE

Working Draft

March 2004

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'. [1]

With just over a decade left to 2015, the governments of developing countries and their donor partners are challenged to achieve the Millennium Development Goal of halving the number of people with incomes below $1/day. 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 not 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 2001, the Development Assistance Committee (DAC) of the OECD published the *DAC Guidelines Poverty Reduction* which provide a robust framework for reducing poverty. The guidelines elaborate a set of six complementary policy elements to address poverty. The first of these is pro-poor economic growth which draws attention to the pace and quality of growth. The Guidelines recognise the importance of 'vigorous, sustained economic growth in the private sector' for providing jobs and incomes for the poor.

In 1995, the OECD had published *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 the developing countries.

These Guidance Notes build on the two Guidelines by elaborating how the private sector can contribute to achieving the rapid, pro-poor growth that is critical for achieving the MDG target. They are divided into two sections: this Concept Note that provides guidance to governments and donors on the conditions that matter for achieving rapid, pro-poor growth and a second paper that will focus on appropriate policies and programmes for bringing about these conditions.

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

SUMMARY

This Note provides guidance to governments and their donor partners on conditions for achieving rapid, pro-poor growth to meet the Millennium Development Goal of halving the number of poor people earning less than a $1 a day.

Poverty Reduction and the Private Sector

The private sector is interwoven into all elements of a robust poverty reduction strategy The DAC Poverty Guidelines provide a robust framework for addressing the multiple dimensions of poverty. The first of the six complementary elements of the framework is pro-poor economic growth. The private sector is the organising principle of economic activity and hence the engine of growth. The pace and quality of growth it delivers, depends upon the institutions that government, through engagement with the private sector and civil society, provides. The private sector also impacts other elements of the framework including basic social services, human security, gender equality and environmental sustainability and is both affected by and affects empowerment.

The Poor contribute to and benefit from growth
The poor actively participate in markets alongside businesses. They are potentially important contributors to growth, as providers of labour and goods and services and as consumers, as well as its beneficiaries. Their marginalisation results in slower, less sustainable growth. For the livelihoods of the poor, what matters is access to and returns from livelihood assets including human, financial, natural, physical and social capital. Access and returns are determined by markets that are created, regulated, stabilised and promoted by institutions. Growth improves both access and returns.

The critical measure of pro-poor growth is the rate at which the average incomes of the poor are rising
To assess the extent to which growth is pro-poor, the critical measure is the rate at which, on average, the incomes of the poor are increasing. Though, overall, increases in the incomes of the poor are linked to growth in per capita income, the relationship varies from country to country and time periods. Comparing the rate at which the incomes of the poor are rising with that required to achieve the MDG, reveals the growth gap that countries must bridge.

Conditions for Pro-Poor Growth

Policies and institutions are required to create incentive for investment drive productivity through efficient resource allocation and provide social justice
Achieving rapid and sustained, pro-poor growth, focuses attention on a set of policies and institutions that address three conditions:

1. That there is sufficient incentive for the private sector, in terms of opportunity and anticipated reward, to take risk and invest. Investment is the key driver of growth.
2. That the organising principle, in which markets drive production, works effectively to deliver efficiency of resource use and gains in productivity. Productivity must increase if investment is to result in sustained growth and this means that resources should flow to their most productive use;
3. Social justice, which helps to increase the pace of growth, sustain growth longer and ensure that the poverty reducing impact of growth is strengthened. It contributes also to human security, mitigating the impact of natural and man made disasters on the poor.

International economic linkages, supported by interventions to facilitate trade, are a major opportunity for pro-poor growth
A major opportunity for the private sector to contribute to rapid, growth is provided by international economic linkages. Openness to trade is associated with higher rates of growth on a sustained basis. To make the opportunity pro-poor, bottlenecks to increased participation in trade, such as trade facilitation, infrastructure and supply capability, need to be addressed. Donor agencies have an important role to play by persuading their governments to make the international trading system more equitable.

Risk and transaction costs depress investment, the driver of growth
In deciding on whether or not to invest, individuals and businesses, implicitly or explicitly, make judgements on the risk adjusted rate of return after tax that the venture is likely to provide. Thus any risk, whether from macro economic instability, sovereign and currency crises, political change or governance, serves to depress the rate of investment. Transaction costs, imposed by information, forms of exchange, transport and costs of doing business, increase the cost base of the venture and so also depress investment. The policies that increase incentive to invest therefore contribute to predictable and transparent rules of exchange with low transaction costs. Instability, particularly crises, hurt the poor disproportionately.

Productivity depends upon flexible, efficient factor markets and creative destruction
Efficiency in resource use depends upon markets, particularly the factor markets for land, labour and capital, working flexibly and without distortions and failures caused by government or the private sector. Market creating and regulating institutions have a vital role to play. In addition, efficiency and productivity are driven by a process of creative destruction, through which the less efficient are driven out and replaced by those more able to create wealth. This requires low barriers to entry and exit.

Social justice leads to higher and longer sustained growth as well as higher poverty reduction
Social justice covers the range of policies that will reduce inequality dynamically and protect the poor during periods of adversity. More equal societies have higher rates of growth and growth is less likely to be derailed by social conflict. The specific policies include redirecting public expenditure to provide basic social services and infrastructure for the poor, measures to establish social safety nets and the promotion of gender equality. Actions to empower women, such as female literacy, have amongst the highest impacts in making growth pro-poor as women have a disproportionate share of poverty and spend more of their income on their children. Increasing the productivity of sectors such as agriculture and the informal economy, on which the poor depend for their livelihoods, helps to make growth pro-poor.

The pattern of growth affects the extent to which growth is pro-poor and sustained. It may be necessary to strengthen growth linkages
Growth may start from a variety of sources, though sustaining growth requires the set of conditions above. Narrow, sector and area specific growth, is likely to prove less sustainable and may have limited impact on the incomes of the poor. Such growth may be broadened and become the basis of sustained growth. Sectors transmit growth to other parts through sector linkages, factor markets and taxation. By strengthening these growth linkages, even the so called resource curse of the extractive industries may be harnessed for pro-poor growth, through tri-partite compacts between the private sector, governments and civil society on resource use. Export oriented, ladder of development industries, such as agricultural commodities and textiles and garments, that are prone to declining terms of trade and falling commodity prices, require investment in human capital and the deployment of that capital to other products and industries if they are to form the basis of broader, sustained growth.

Markets may be made to work for the poor through institutional change and the development of linked markets to increase competition

It is important also that markets work for the poor, particularly those from which they derive their livelihoods and satisfy their consumption needs. Markets work based on formal and informal rules of the game. Value chains may be producer or consumer driven and this affects the returns to the poor. Institutional change may help make market outcomes pro-poor. Outcomes for the poor depend also on the extent of market failure and the relative market power between stages in the value chain. Addressing market failure through appropriate institutions and the development of weak or missing linked markets may have pro-poor impact. Competition is the key to market deepening which improves access and returns for the poor.

Conditions for Private Sector Development

The entrepreneurship and productivity of the private determine the pace at which the private sector responds to these conditions

The conditions above provide the private sector with the opportunity and incentive to grow rapidly. However, the pace at which it responds depends upon its capabilities and productivity.

Entrepreneurship is the basis of creative destruction

The observed differences between countries in the rates of business formation are a function of history, culture and attitudes on the part of government and civil society, Signaling a change in attitude, marked by reducing entry barriers, the cost of doing business and the reduction of bureaucracy may stimulate a string response from the private sector. The strong response to such measures in the formerly centrally planned economies of China and Vietnam provide the evidence for this.

The informal economy is a response to risk and transaction costs and an aversion to bureaucracy. The very high rates of informality seen in Africa, Latin America and South Asia are evidence of a lack of job creation in the formal sector and poor conditions for private sector development. Countries with the highest cost of doing business and the greatest number of procedures for business registration also have the highest rates of informality. Low productivity in the informal sector may be reducing allocative efficiency. It must be addressed to increase pro-poor growth. As consumer served by the informal sector, the poor frequently pay higher prices for their goods and services than their richer counterparts.

Entrepreneurs frequently lack business management skill

Government and donor provided business development services (BDS) should not reduce the incentive for the private sector to provide these services. Whilst addressing a well recognised need, interventions that have provided BDS services free or by subsidising demand, may have stifled the growth of supply of these services in the private sector. Supporting the growth of the supply of these services in the private sector, through training and accrediting low cost providers, is likely to prove more sustainable long term.

Innovation leads to productivity gains driven by competition and enabled by investment

The likelihood of new ways of meeting the needs of consumers and increasing productivity that drive creative destruction are more likely when competition is intense. Protected industries have less incentive to innovate. Innovation requires investment and is enabled by sufficient incentive for investment.

Business networks, especially clusters, are conduits of innovation and increase productivity through specialisation and flexibility

Increasingly, flexibility in responding to market demand and focusing on core competence are sources of competitive advantage. Horizontal and vertical clusters and business organisations

help to spread innovation and take advantage of economies of specialisation. Co-operation between businesses can be improved by formal and informal institutions that provide security of contract.

Increasing access to finance requires a systems approach. One off interventions are unlikely to be sustained. Financial depth, as measured by the ratio of bank deposits to GDP, is correlated with the rate of growth. It is a critical factor in the rate of investment and hence innovation and lack of access to finance is part of the poverty trap. However, government or donor provision of subsidised finance to businesses or the poor is unsustainable and may block financial deepening. A systems approach that addresses the causes of poor rates of saving and the flow of capital to its most productive use is likely to prove more sustainable. Developing weak or linked markets, such as wholesale finance markets, and helping the institutions that serve the poor to access them appears to offer greater promise.

Delivering pro-poor change is a process that requires engagement between government, the private sector and civil society

Whilst broad guidance may be provided on priorities and sequencing, changing behaviour involves changing views and attitudes. Prioritising and sequencing change should therefore reflect the views of key stakeholders. Donors may support and enable such engagement. Overcoming resistance to change is likely to require building issue based constituencies that can persuade those opposed to change through evidence based analysis and technical solutions to meet their objections. Local agents of change are best placed to build such constituencies. Donors should aim to change the system without becoming part of the system.

I. PRO-POOR GROWTH AND THE PRIVATE SECTOR

Poverty has many dimensions and addressing its causes requires the concerted attention of government, the private sector and civil society. This chapter explores the ways in which the private sector impacts poverty reduction and the livelihoods of the poor and considers what constitutes pro-poor growth.

Poverty Reduction and the Private Sector

…poverty is multi-dimensional

As the DAC Poverty Guidelines and other frameworks for poverty reduction recognise[2], poverty is multi-dimensional. In addition to low incomes, it is characterised by a lack of access to assets that undermine the capability of the poor to earn their livelihoods, by a lack of voice in shaping policies that affect their lives and by a vulnerability to natural and man made shocks and disasters. To address these multiple dimensions, the Poverty Guidelines state that a strategy for the sustainable reduction of poverty has to have the following six complementary policy elements:

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 right 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;
- Mainstreaming environment environmental sustainability using sustainable livelihood approaches. Achieving the MDGs calls for an integrated approach combining economic and social development and environmental sustainability.

The private sector is the organising principle of economic activity

The private sector is more than businesses

Whilst for many, the term private sector conjures up the image of a business, with employees, 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'*.

[2] For instance, World Development Report 2000/1 Attacking Poverty, World Bank.

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 the very large, multinational corporation.

The private sector includes farmers and multinationals participating alongside each other in markets

The poor are active participants in the private sector
The poor are not merely the recipients of the jobs and incomes provided by businesses but also participate alongside businesses in economic exchange. The activities they all engage in, from farmers to multinationals, and the incomes they earn, are determined by outcomes in the markets in which they participate.

The pace & quality of growth is influenced strongly by institutions
The private sector is the engine of economic growth. Growth is simply the sum of the increase in value added by the activities of thousands of participants engaged in market exchange.[3] The environment in which it operates, made up of institutions[4] that make and administer the rules of exchange and the level of development of the private sector, have a strong bearing on the pace and quality of growth, the first of the six elements of a robust strategy for reducing poverty. The role of institutions is critical. The organising principle needs appropriate 'rules of the game' that ensure that market signals lead it deliver rapid and sustained, pro-poor growth.

It influences other dimensions of poverty
The private sector influences also success in bringing about other elements of the framework for reducing poverty. Governments rely on taxing the wealth created by the private sector to fund the basic social services that ensure that the poor have access to the assets they need to lead productive lives. The sustainability of growth influences the extent to which the poor are exposed to economic shocks and their ability to withstand them may be enhanced by opportunity to earn incomes from a diversity of sources. Income equality for women is determined by both their access to assets and the outcomes of market exchange. As the major user of resources, the private sector has a strong influence on the extent to which environmental sustainability is mainstreamed in economic and social development.

Even empowerment, which is largely the result of political processes, is intimately connected with the private sector. The institutions that govern market exchange may be more or less pro-poor, depending on how much influence the poor have had on them. The outcomes of market exchange determine who gains and who does not and so are inextricably linked with political economy. The private sector is thus woven into all the six elements of a poverty reduction strategy.

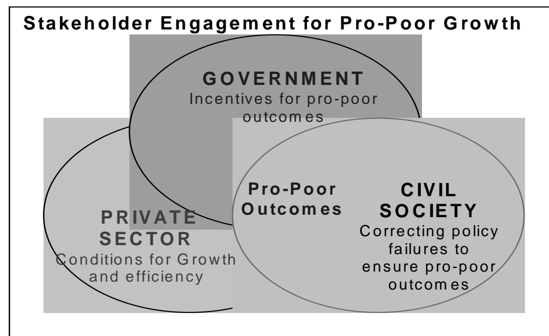
The private sector should form part of PRSPs

Poverty Reduction Strategies need to address the private sector
Poverty reduction strategies, whether prepared by heavily indebted countries as their Poverty Reduction Strategy Paper (PRSP) or not,

[3] 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.
[4] Throughout this Note, the word institutions is used to mean the rules of the game (formal and informal), the governance exercised over their implementation and the organizations responsible for that governance.

therefore, need to address the role of the private sector in delivering rapid growth and delivering pro-poor outcomes through the quality of growth. They need to recognise that developing the institutional framework will require consensus to build across government, the private sector and civil society.

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.



How do the Poor Participate in and Benefit from Growth

The poor contribute to growth and benefit from it

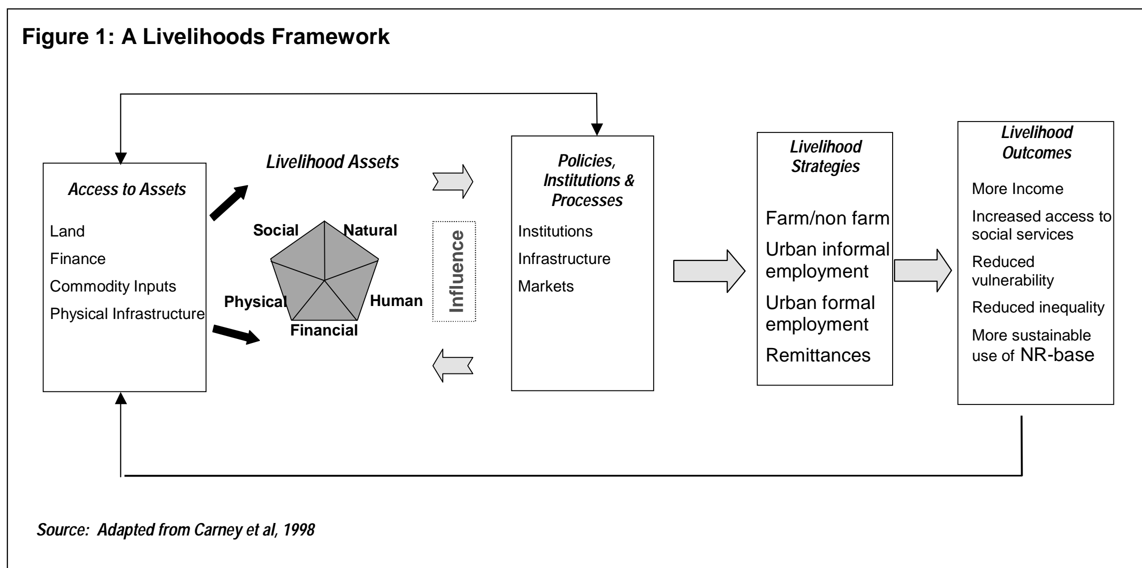
The poor are active participants in the growth process, not the passive recipients of growth delivered by businesses and governments. They contribute to growth as well as benefit from it. Their individual incomes may be low but, in aggregate, the way they earn their livelihoods impacts growth and they form a major category of consumer the inclusion or exclusion of which in markets has major growth impacts. Not only are they providers of labour, they are also a source of capital, particularly if their property rights are recognised.[5]

Growth impacts access and returns to livelihood assets

The poor earn their livelihoods in a variety of ways. They may be providers of labour, farmers, artisans, entrepreneurs in the informal sectors and providers of services and, often, they earn them through a combination of these. Which ever way they earn their livelihood, they use a combination of the assets that they possess, be it simple labour or a skill that they learned, land that they may have access to, whatever financial capital they maybe able to raise and their social networks. What matters to the poor is their access to these assets and the returns that they earn from them in markets, as shown in figure 1. Growth affects both the access to assets and the return from them.

[5] Hernando De Soto

Figure 1: A Livelihoods Framework



Source: Adapted from Carney et al, 1998

Growth may increase wages and make health education accessible

As suppliers of labour, the poor benefit from growth, through increased demand for labour and, over time, higher wages. For many of the poor, finding a decent job is the most obvious way to escape poverty. Countries that have undergone rapid, labour intensive growth, such as Vietnam, have been able to reduce poverty rapidly. Job creation has led to falling unemployment and wages have near trebled.

> "First, I would like to have work of any kind."
> **An 18 year old man from Ecuador**

Growth improves access to basic social services of health and education, through government and, as incomes rise, private sector provision. Thus growth should result in increased labour productivity and human capital, setting up a virtuous circle as rising productivity per worker is a major contributor to growth.

It should increase demand for products & services they produce

Economic growth increases opportunities for improving livelihoods

The poor as farmers and entrepreneurs (artisans, providers of services) depend upon the process of market exchange that will determine the incomes they earn. With the economy growing rapidly, the demand for the products and services they produce should rise quickly and this provides the poor with opportunities to improve their livelihood, particularly if the appropriate institutions and infrastructure are in place.

The poor frequently rely on natural resources of land, the forests, rivers and lakes for their livelihoods. Provided governments can ensure the sustainable use of natural resources, growth should provide the basis of a sustained increase in incomes from forestry and fisheries, tourism and other activities based on natural resources. Even in urban areas, access to land for a dwelling can make a huge impact on poverty, particularly if the poor can be exercise their rights to borrow against and sell the title to property. As growth occurs, markets for land should develop and help to raise the value of the property thus addressing poverty.

Farmers and entrepreneurs need access to finance and financial services. Growth is correlated with financial sector deepening that should improve access to finance through wider branch networks and more efficient banking services. Non banking sources of credit are likely to increase. Suppliers may offer credit and customers advances against receipt of goods or loans against the crop through depository schemes.

There were two women who would not have got credit anywhere, but we assisted them and today they are sewing new dresses and sending their children to school.
Manager, Community Bank, Nigeria

The poor impact growth through consumption and benefit from market deepening

The poor participate in and benefit from growth not only through its effect on their livelihoods but also upon them as consumers. The world's poor may have low incomes but their sheer number make them an important influence on consumption. As growth occurs and markets deepen, the access of the poor to goods and services should increase and the prices they pay for essentials such as food should fall. Currently, the poor frequently pay the highest prices for goods because of the long distribution chain to reach them. As markets deepen, these chains should shorten allowing the poor to consume more products and services.

The world's 4 billion consumers represent a potentially huge market for businesses to address. Prahlad & Hammond, 2002

What is Pro-Poor Growth

The aim of this paper is to examine the conditions that affect the pace and quality of growth and so matter for the private sector to deliver rapid, pro-poor growth. But what, precisely, does pro-poor growth mean?

Growth is necessary for Poverty reduction

There is now widespread agreement that increasing average incomes (GDP per capita) is a necessary condition for reducing poverty and that the higher the rates of growth the more rapid poverty reduction, especially if they are sustained for a decade or more[6]. Across countries and time periods, it has been found that, on average, there is a one to one relationship between average incomes and the incomes of the poorest fifth of the population[7], so if average incomes are rising rapidly, so will the incomes of the poor. Over long time periods, between 66% - 90% of the reduction in poverty can be explained by changes in average incomes[8].

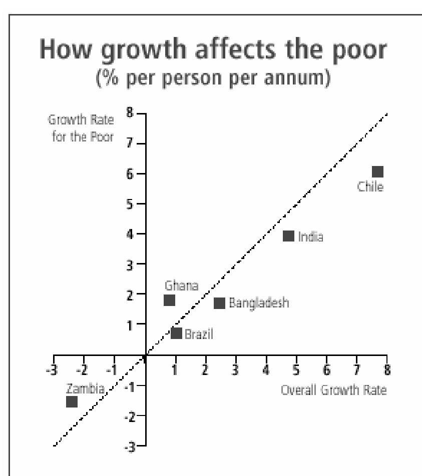
In the short to medium term though, changes in average incomes explain roughly half of the changes in poverty. There are examples of short periods of growth in individual countries that have not had much impact on poverty [9]and even a few that appear to have had negative impacts. Such episodes draw attention to the issue of the extent to which the poor benefit from growth.

Over the long term between 66%-90% of the reduction in poverty may be explained by changes in average incomes

[6] Art Kraay 2003
[7] Dollar & Kraay
[8] Art Kraay.
[9] Ravallion 2002, Bourguignon 2001

But the effect of growth on the incomes of the poor varies
Figure 2 shows that, though in general, the incomes of the poor change with average incomes, the relationship between the growth of average incomes and the growth rate of the incomes of the poor varies significantly across countries[10]. Whilst growth in 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 fell in Ghana. Inequality would fall in all countries above the 45 degree line in figure 2, including Zambia, where the incomes of the poor fell by less than average incomes. In all countries below the 45 degree line, inequality increased.

Figure 2



Source: DFID Pro-Poor Briefing Note 1, February 2004

For poverty reduction, the rate at which the incomes of the poor is crucial
The variation in the relationship between average incomes and the incomes of the poor has prompted a divergence of views of what constitutes pro-poor growth. For some[11], growth is pro-poor when the incomes of the poor are rising *relative* to average incomes. For others[12], what matters is the *absolute* rate at which the incomes of the poor are rising. Governments have a choice as to how they define pro-poor growth and some have decided to define it in relative terms. But there does appear to be a trend to use the absolute measure, for two compelling reasons:

The absolute rate at which the incomes of the poor are rising determines the reduction in the poverty headcount

- Because the MDG is based on reducing numbers of the poor, what matters most to its achievement is the reduction in the poverty headcount, brought about by the growth in the incomes of the poor;

- The most dramatic reduction in the poverty headcount has been achieved by the East Asian countries. In these countries, the incidence of poverty and the headcount have fallen but inequality has increased. Using the relative measure would mean that growth in these countries would not be considered pro-poor, though the

[10] Dfid Briefing Note.
[11]
[12]

outcome, in terms of incomes and living conditions, would argue otherwise.

▪

Inequality affects the rate of growth, its sustainability and poverty reduction

It should be noted, however, that even if the absolute measure is used, inequality remains an important consideration for governments and their donor partners. The more equal the distribution of income, for any given rate by which the incomes of the poor are rising, the greater the numbers of the poor that will be raised out of poverty, the faster the growth and the more sustainable, as discussed in Chapter II below.

The more equal the distribution of income the faster and longer sustained growth is likely to be and the greater the impact of growth on poverty

The key measure is the rate at which the average incomes of the poor are rising

There is debate also on what is the right measure of the rate at which the incomes of the poor are rising. Should it be the incomes of those who are marginally poor, as it is this that will have a crucial bearing on reducing the poverty headcount? Or should it be the rate at which 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?[13]

Again, governments have a choice in this regard. However, a consensus seems to be emerging that the appropriate measure is the rate of growth of the average incomes of the poor[14]. 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.

Monitoring the rate at which the average incomes of the poor are rising reveals whether the income goal of the MDGs will be met

Pro-Poor growth is a rate not a state

The critical point that emerges is that pro-poor growth is a rate not a state. It is the rate at which the incomes of the poor are rising on average. By focusing on this measure and taking account of the average incomes of the poor, it becomes possible to assess whether the MDG target is likely to be met. Guidance on how it can be calculated is available through the internet on ……………

[13] Klasen's weighted incomes
[14] Ravallion & Chen, the Watts Index.

II. CONDITIONS FOR PRO-POOR GROWTH

This chapter focuses on the conditions that are likely to promote, rapid pro-poor growth. For some governments, the challenge is to increase economic growth to levels that have never been achieved before on a sustained basis. For others, there is a need to ensure that growth has a greater impact on poverty reduction than heretofore. This chapter provides a framework for governments and their donor partners to analyse the causes of the bottlenecks to the private sector delivering rapid, pro-poor growth. It starts with the necessary conditions for delivering rapid, pro-poor growth, then focuses on the pattern of growth before considering how market access and functioning affect poverty outcomes.

The Conditions for Rapid, Pro-Poor Growth

Consensus has emerged on policies and institutions for pro-poor growth

Governments, faced with the challenges of increasing the rate of growth, sustaining high growth and making growth pro-poor, need to consider, in conjunction with the private sector and civil society, whether appropriate conditions exist for the private sector to deliver these outcomes. Over the past two decades, a consensus has emerged over a set of policies and institutions that are necessary conditions for rapid, sustained pro-poor growth. These policies and institutions have been validated by evidence based research.

This set of policies is aimed at addressing three conditions that may be considered necessary for the private sector to deliver rapid pro-poor growth[15]:

- Sufficient incentive for the private sector to take risk and invest in productive capabilities to increase the rate of growth;
- Effective functioning of the organising principle that is the private sector to increase productivity and deliver efficient, pro-poor outcomes;
- Social justice and poverty alleviation to ensure that social cohesion is maintained and that the poor are able to participate in and benefit from growth thus leading to faster growth of average incomes and the average incomes of the poor.

Opportunity and anticipated reward drive risk taking

Incentive, combining opportunity & likely reward, drives growth

The concept of *incentive* is critical to understanding the way the private sector drives growth. Incentive refers to both opportunity and the anticipated reward from the opportunity. The focus on opportunity highlights the need for the private sector to have access to markets, both domestic and international. This focuses attention on policies to liberalise sectors of the economy previously reserved for the public sector and to privatise commercial businesses so that they do not compete with the private sector on unfair terms. To ensure pro-poor outcomes, it is important that the processes of liberalisation and privatisation safeguard the public interest and do not comprise the provision of essential services to the poor.

[15] Growth Strategies, Dani Rodrik, Harvard University, Sep. 2003, Sida: Approach to and Organisation of Support to PSD, 2001

International economic linkages represent a major growth opportunity

The critical area to address for opportunity is international economic linkages. There is substantial evidence to suggest that greater openness to trade, as measured by the ratio of exports and imports to GDP, is associated with higher rates of economic growth[16]. Establishing conditions that lead to greater openness and ensuring trade facilitation through addressing bottlenecks to international trade result in rapid growth. To ensure pro-poor outcomes, it is essential that the constraints on capability and competitiveness and infrastructure bottlenecks that limit the participation of the poor in international trade are addressed.

Openness to trade is correlated with rapid growth

Donor partners can help to reform the international trading system

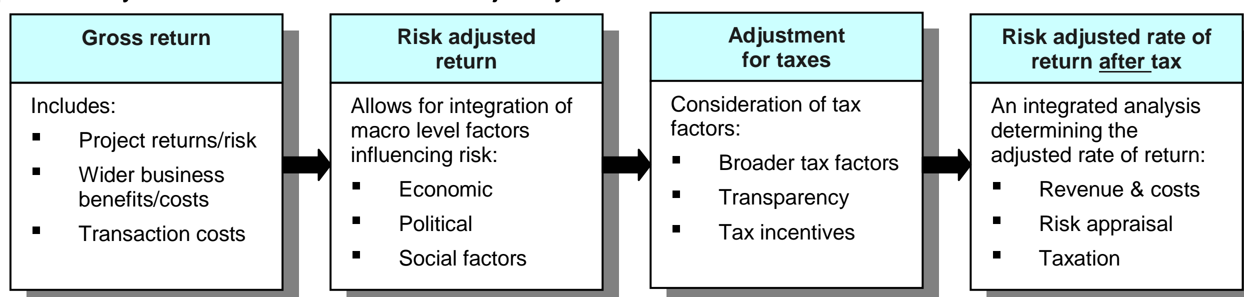
Donor partners have an important enabling role to play by helping to make the international trading system more equitable. They can influence their own governments to reduce subsidies on agriculture and the proliferation of technical barriers to trade (TBTs) that already affect over 90% of trade in goods and represent substantial impediments to market access.

Investment is the critical factor for growth

The critical driver of growth is that individuals and businesses are motivated to take risk and so invest in increasing wealth creation. Investment is the critical driver of growth. Growth, measures changes in the output of an economy. Output is simply the stock of the factors of production (land, labour and capital) multiplied by the productivity of each factor[17]. Investment increases the stock of capital and improves its productivity and that of other factors of production. A high rate of investment is one of the key differentiating factors of countries that have enjoyed high rates of sustained growth and those that have failed to do so.

The East Asian economies that have achieved high rates of growth sustained GDI/GDP ratios in excess of 30%. The low growth African countries struggle to achieve ratios over 20%.

The private sector seeks to maximise the *risk adjusted rate of return net of tax* offered by investment opportunities. Figure 3 below illustrates the processes that more sophisticated businesses use in determining their returns to a venture. Though individuals and micro and small businesses may not use the exact process, they do take the major factors into account in an unstructured way. The higher the risk, the greater the profitability of the venture has to be to justify the investment.



[16] When is Growth Pro-Poor, Art Kraay, Dec 2003, Dollar & Kraay,2000, Trade, Growth & Poverty, 2000

[17] Given constant returns to scale, Euler's theorem states that GDP (output, Y) is given by $Y = KF_K + LF_L$ where F_K and $_{FL}$ are marginal productivity of labour(L) and capital(K) respectively.

The higher the transaction cost[18], the higher the returns have to be before these costs are taken into account. Both risk and transaction costs thus drive down investment and with it growth.

The critically important policies that impact the incentive for growth are:

Policies for Incentive	Effect on Private Sector/Pro-Poor Outcomes
Liberalisation ▪ Deregulation and privatisation whilst protecting the supply of essential services for the poor	▪ Opportunities for the private sector to participate in previously excluded sectors on equal terms. Markets made attractive by lifting price controls whilst protecting essential services for the poor.
International Economic Linkages ▪ Openness to trade ▪ Rule based trading systems (WTO, RTAs) ▪ Competitive exchange rates ▪ Building domestic capability to trade & compete ▪ Prudent borrowing from abroad	▪ Openness to trade provides opportunity for the private sector in export and import market ▪ Uncompetitive exchange rates and imprudent borrowing from abroad exposes the country to currency and sovereign risk which leads to economic crises that hurt the poor disproportionately ▪ Domestic capability to compete built to ensure growth and opportunities for the poor
Macro economic stability ▪ Monetary & fiscal discipline ▪ Reducing the size of government ▪ Wider tax burden	▪ Reduced risk from inflation and contraction of the economy, less competition from the public sector for capital, lower cost of capital, lower tax burden leading to greater incentive to invest ▪ The anti-poor effects of inflation mitigated
Investment policies ▪ Investment facilitation, cost of doing business, FDI policies, transparent business regulations with low cost of doing business	▪ Supportive institutions resulting in lower regulatory risk, lower transaction costs for investment and hence greater incentive to invest
Governance ▪ Transparent business regulations, security or property rights, enforcement of contracts, rule of law, anti-corruption	▪ Lower regulatory and governance risk, ability to leverage property as collateral, lower operational risk from failure to meet contracts and lower risk and cost of business from anti-corruption ▪ Poor are particularly disadvantaged by governance failure

[18] Transaction costs – The costliness of information is the key to the costs of transacting, which consists of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements. (Douglass North, 1990)

The organising principle should be effective and deliver productivity gains, though transparent, predictable rules of exchange

Economies such as the US with low (20%) GDI/GDP ratios may still sustain growth if productivity is rising rapidly

Apart from driving growth through investment, the critical role of the private sector is that, through markets, it serves as the organising principle of economic activity. The market provides the signals that drive what is produced and how much. In addition to investment, growth is driven by the effectiveness of the organising principle in delivering static (technical) and dynamic (allocative) efficiency, as measured by levels of productivity.

For investment to have the effect of sustaining growth, it must be directed to the most productive (efficient use). That way, the increased output results in additional resources for investment, thus creating a self sustaining cycle. Although the level of investment is important, it must be allied to gains in productivity. Where countries have not had mechanisms in place to ensure efficient allocation of investment, as was the case in the communist countries of Central and Eastern Europe, then even a high rate of investment will not deliver high rates of growth and growth is unlikely to be sustained.

Competition drives productivity through creative destruction

The critical requirements for ensuring high levels of productivity are that there are competitive markets and that resources are allowed to flow to their most productive use. Competition is the main driver of productivity. The process of the development of the private sector and its ability to innovate to improve productivity and add value is likened to *creative destruction*[19]. Those unable to innovate and compete 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 there is a hard budget constraint, so that governments and the banks do not keep on bailing out the inefficient. Innovation and its driver competition can be encouraged whilst protecting the rights of shareholders and creditors.

Efficient factor markets contribute to allocative efficiency

For resources to flow to the most productive use, markets for capital, labour and land, the factors of production, must work effectively. They must be able to respond to the signals of the market and, in turn, those market signals must not be distorted by market failures caused by poor information, monopoly or monopsony power and, inappropriate government policy. To protect the public good, confidence in the banking system, protection of the rights of labour and developing markets for land that recognise traditional rights are vital. But these regulations need to be framed in ways that do not hinder the flow of resources to the most productive use or distort markets to prevent efficient outcomes. Ideally, all markets for goods and services should be competitive and free from market failure. Institutions for ensuring competition by addressing monopolies and mergers and removing restrictive practices are therefore essential features of a pro-poor institutional landscape.

[19] Schumpeter. *Capitalism, Socialism and Democracy* (New York: Harper, 1975], pp. 82-85:

Policies for Efficiency	Effect on Private Sector/Pro-poor Outcomes
Entry & Exit Barriers ▪ Business registration, cost of doing business ▪ Hard budget constraint ▪ Bankruptcy procedures	▪ Incentive to develop new businesses, level playing field with public sector/other competitors exit from unprofitable investments to profitable
Competition Policies ▪ Monopolies and mergers ▪ Restrictive practices	▪ Forces of competition drive technical efficiency, markets provide appropriate price signals and the small are not deterred by the market power of the large
Correcting Market Failure ▪ Aligning private and public benefits ▪ Public provision of public goods ▪ Addressing information asymmetry ▪ Developing linked markets	▪ Market prices are aligned to public benefits, there is adequate supply of public goods, transaction costs are lowered and linked markets are not prevented from developing leading to deeper markets with pro-poor outcomes
Capital Markets ▪ Interest rate liberalization ▪ No policy directed lending ▪ Financial codes & standards ▪ Corporate governance ▪ Central banks targeting inflation independently	▪ Incentive to save increasing the supply of capital, security and better returns for investors thus adding to stock of capital, lower inflation benefiting investment and the poor.
Labour Markets ▪ Core labour standards, ▪ Health & safety ▪ Realistic minimum wages ▪ Flexible labour markets ▪ Information on opportunities ▪ Vocational training	▪ Protecting the rights of labour including right to a safe working environment, realistic minimum wages and procedures for terminating employment that do not discourage employers, information on jobs and skills to improve the match between demand and supply, lead to a more productive work force for employers and higher wages and better working conditions for employees
Land Markets ▪ Secure property rights ▪ Ease of ownership transfer ▪ Sustainable land use	▪ Land may be used as collateral and a market develop for land that allows it to be used for the most productive use within a system of planning. Sustainable land use protects the traditional rights of the poor, prevents conflicts over land and ensures environmental management.

Social Justice contributes to faster, sustained, pro-poor growth

Important as the above policies may be, they may not be sufficient to ensure rapid and sustained, pro-poor growth. The pace of growth is strongly affected by how broad based growth is, particularly the extent to which the poor are involved. As shown in chapter 1, the poor are active participants in the growth process as consumers and producers, providers of labour, land and even, capital. If the poor were excluded from the growth process, countries with high poverty incidence would be disadvantaged compared to those with lower poverty incidence in terms of the pace of growth they may achieve. In effect, only a small proportion of consumers and the work force of such countries contribute to growth.

Low initial inequality of incomes has been found to be associated with higher rates of economic growth subsequently[20]. The relatively even access to assets that equality creates enables a greater proportion of the population to participate in the growth process, with fewer excluded by their lack of access to assets. Low inequality also leads to less social tensions and potential for conflict. And conflict almost always brings growth to a halt as it disrupts the processes of market exchange and increases risk of damage or seizure of property, causing a disincentive to invest.

Greater quality helps sustain faster growth with higher rates of poverty reduction

Thus policies that support social justice lead to faster, sustained rates of growth. They also help to make growth pro-poor. For instance, female literacy has been found to be one of the most important determinants of the extent to which growth in aggregate results in higher incomes for the poor, a high proportion of the poor being women. Higher incomes for women also result in greater impacts on other measures of poverty as women spend more of their incomes on food, health care and education for their children.

Productivity in sectors of the economy from which the poor earn their incomes is particularly important for making growth pro-poor. The poor are concentrated in rural areas and their livelihoods depend on agriculture and related non-farm activities. Growth is likely to be led by sectors that may have higher productivity and this should increase allocative efficiency. Migration away from agriculture should increase agricultural productivity. Rising agricultural productivity then helps to sustain a process whereby non-farm growth leads to higher agricultural incomes which help provide opportunities for non-farm incomes. The labour market and wages play a key role in ensuring that growth is pro-poor with wages increasing as a result of higher productivity in both farm and non-farm activities[21]. A similar argument holds for the informal sector which provides incomes for a high proportion of the poor, particularly in Sub-Saharan Africa and South Asia.

[20] World Development Report 2000 and many other papers.
[21] Datt & Ravallion

Policies for social justice have the multiple effects of increasing the rate of growth, sustaining for longer, making growth pro-poor and improving other measures of poverty. They should be considered an integral part of the package of policies that bring about conditions for pro-poor growth.

The main policies for social justice are:

Policies for Social Justice	Effects on Private Sector/Pro-Poor Outcomes
Redirecting Public Expenditure ▪ Focusing public expenditure on health, education for the poor ▪ Infrastructure, particularly in areas in which the poor live	▪ Increased productivity of labour and accumulation of human capital that will help to increase growth and the incomes of the poor. Better access to markets for the poor.
Social safety nets ▪ Food for Work ▪ Social insurance ▪ Vouchers, subsidies for essentials	▪ Mitigate vulnerability to economic downturns, natural disasters, ensure continued participation in the economy
Gender Equity ▪ Institutions ▪ Literacy, skill entrepreneurship training ▪ Access to natural and financial capital ▪ Women's organisation, voice	▪ Greater participation and labour productivity contributing to poor-poor growth, increasing entrepreneurship skills in informal economy
Social Cohesion ▪ Institutions for ethnic discrimination ▪ Public not club goods ▪ Mitigating conflict ▪ Building bridging and linking capital	▪ Prevents conflict thus reducing political risk, opens up market opportunities previously reserved by particular social groups, builds co-operation between groups in economic exchange and facilitates access to decision makers to influence policy
Productivity of Agriculture/informal businesses ▪ Access to information, training and knowledge services ▪ Access to capital and physical inputs ▪ Access to markets	▪ Increasing productivity of the poor enables them to contribute to and benefit from growth, increasing the rate of growth and growth of incomes of the poor

The Pattern of Growth: broadening and sustaining growth

The Poverty Reduction Guidelines include under the quality of growth its composition. Composition matters because growth may be either narrowly based, confined to a few sectors and regions, or broad based, spreading across sectors and regions. Broad based growth is likely to be sustained longer and more pro-poor than growth which is narrow in its coverage.

Broadening and sustaining growth through sector linkages

Growth may start from a huge 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 policy change. The more sustained growth spurts are associated with a set of policies of the type discussed above,[22] but there are also many other instances of shorter lived growth spurts that have been confined to particular sectors. Even in the low growth economies, including those of Sub-Saharan Africa, there are sectors such as agriculture sector or other natural resource based industries that are growing rapidly. It may be possible to harness these narrower growth spurts for broader based growth that will be sustained longer

Patterns of growth may be more or less pro-poor

Even when growth is rapid and sustained, there may be regions that do not benefit from growth, as is the case in western China and parts of Vietnam today. What has proved difficult is to spread the benefits of growth from the coastal regions or the major cities to other parts of the country.

Growth linkages to other sectors may be weak

Sectors have different mechanisms for transmitting growth to the rest of the economy. They may have forward and backward linkages with other sectors of the economy, establish competencies that may be useful for other sectors and impact factor markets so that they transmit growth by increasing demand for labour, capital and land. There are some sectors, such as the extractive industries, whose main [23]transmission mechanism is taxation. These transmission mechanisms may be weak thus confining growth to a particular sector.

An acute example of weak or even negative transmission is the ‘resource curse’ of the extractive industries[24] that affects over 20 developing countries. The mining of minerals and the oil & gas industries frequently have a major growth impact through investment and the high value added by operations. The foreign exchange they provide should help to strengthen the balance of payments.

In practice, though, many of these countries have witnessed slow growth, are prone to conflict and have witnessed an increase in poverty. The ‘Dutch Disease’ effect of an overvalued exchange rate has often

[22] Rodrik,2003
[23] Eme, forthcoming
[24] Sachs & Warner

caused other tradeable sectors such as agriculture and manufacturing to decline resulting in slow growth and poverty. The local community, instead of benefiting, has suffered social dislocation and environmental degradation. Corruption has become widespread and patrimonial government has increased social tensions.

Even sectors with weak linkages can be harnessed for broad based growth

The critical transmission mechanism is royalties and government revenues. The sector has few other linkages as it is not labour intensive and imports a lot of its inputs. The way that royalties and governments are used will determine whether resource is a curse or an asset.

Negative transmission is not inevitable. Sterilisation or stabilisation funds can mitigate the effect on the exchange rate, directing funds towards private sector investment can increase the capacity of the economy to absorb foreign exchange and government revenues, instead of being used to pay civil servants wages, can be focused on social services and infrastructure, thus contributing to pro-poor growth. Corruption can be addressed by initiatives for both governments and the private sector to disclose information. Tri-partite partnerships between government, private sector and civil society can form the basis of compacts and plans to use the wealth created for development, including development plans for communities and regions that are affected.

Ladder of development industries should provide the basis for diversification

All the export oriented 'ladder of development' industries, including agricultural commodities, agribusiness and labour intensive manufacture of textiles, clothing and footwear and electronic assembly, are prone to declining terms of trade. Reliance on these industries exposes the economy to the risk of sharp contractions, when commodity prices fall, the country loses its comparative advantage or the main export markets experience cyclical down turns. These contractions frequently hurt the poor disproportionately.

The critical transmission mechanism for growth of these industries is labour markets. Growing demand for labour will have pro-poor impacts in the rest of the economy. To reinforce these, the critical requirement is to continue the process of productivity increase and value addition in the industry itself and to spread the human capital, entrepreneurship and technological advancement, that gave rise to international competitiveness to other products and sectors of the economy.

The ladder of development industries is where developing countries inevitably start. But excessive reliance on them may not lead to sustained pro-poor growth. Instead, their growth needs to serve as a demonstration of what is possible and a process initiated to replicate the conditions for their success to other products and sectors through their growth linkages. This is likely to entail identifying changes in policy and private sector development initiatives of the type discussed in chapter III.

Area based programmes have a role to play

In its initial stages, growth is likely to have narrow geographic boundaries. Where the source of growth is a natural resource endowment or is based on location advantages such as proximity to ports, the spread of growth to other parts of the country may be slow. Of course, migration to areas where growth is occurring and the attendant remittances will serve to transmit growth wider, but it is possible to end up with two speed growth of a country, with booming coastal regions and a high poverty incidence hinterland, as is the case in China.

In the face of this, governments have attempted regional investment incentives, in the form of higher tax relief and lower minimum wages. These incentives frequently do not work or, if they do, serve to divert, not add to growth. The disadvantaged areas struggle to duplicate what the better placed areas do.

Tax incentives divert rather than contribute to growth

The less developed regions need to develop conditions that will spur their own growth, based on their own comparative advantages. The fast growing regions may provide opportunities for these regions to supply goods and services. Area based programmes that include improving the incentive to invest, the provision of social services, infrastructure and developing services that boost the productivity of the private sector in the less developed regions may help to accelerate the spread of growth from the more developed regions.

Making Markets Work for the Poor

For the organising principle to work effectively to deliver pro-poor growth, it is essential that markets, which drive production, are accessible to all and that outcomes are determined on the basis of competition in a level playing field, not pre-determined by market power or asymmetric availability of information. Institutions need to protect against market failure and provide incentives for growth and pro-poor outcomes.

Market failures deny access and lead t poor returns for the poor

In reality, such conditions may not exist. Inappropriate regulations and other market failures may deny access or lead to low returns for the poor. If such failures occur in markets from which the poor earn their livelihoods, they will serve to increase exclusion and reduce the benefits of growth for the poor. Governments, in consultation with the private sector and civil society, need therefore to monitor market outcomes and, where there are failures, identify their causes, starting with markets that matter for the livelihoods of the poor and that meet their consumption needs.

The poor may be denied market access by institutions, transaction costs, market failures and social structures

The rules of the game serve to either make markets accessible to the poor or deny them access. These rules may be formal or informal and either may deny access. For example, in the financial sector, the

insistence by the formal sector on collateral, even for micro loans, may deny access whilst the informal financial sector, with its focus on mutual guarantees and peer pressure, is able to provide access to the poor. In the market for land, on the other hand, informal rules, based on tradition, may deny women rights to land.

Both formal and informal rules may deny access

Transaction costs of transport, poor information and contract enforcement deny access to the poor and may be so high that they prevent the development of linked markets which prevents market deepening. Transport costs are a prime example of how access may be denied the poor. The cost of transport from a rural area, served by poor roads on which small pick-up trucks may operate, to the main road may be as high as that from the main road to the town or city that is the final destination. Whilst those living along the main road may be able to earn a reasonable return, those in the hinterland, engaged in the same activity, may find it uneconomic.

Transaction costs can lead to missing linked markets which prevents market deepening

Examples of linked markets not developing because of high transaction costs include access to formal banking. The cost of processing a micro loan is not much different to a large loan. Loading the additional cost on to the micro loan may make the loan unaffordable. So, banks shy away from this type of lending. The lack of markets for livestock and crop insurance are also examples.

State intervention may deny access

Market failures may be caused by either the state or the private sector. The state may intervene in markets, often with good intent, in ways that lead to exclusion. Fertiliser subsidy is a good example. In order to make it more affordable by the poor, governments the world over have subsidised fertiliser. There is, however, never enough to go round, so providing subsidised fertiliser becomes a form of patronage. The majority of the poor, however, receive no fertiliser at all. The private sector does not fill the gap left by the state because it may be faced with competition from subsidised fertiliser.

Market failures caused by the private sector include information asymmetry and concentration of market power. Normally, the fact some market participants have better information than others, frequently the poor, leads to lower returns for the poor. But in extreme cases, it may mean complete ignorance on the part of the poor so that they fail to realise the opportunity altogether. Similarly, strong market power usually ends up with lower returns for the rest. But in extreme cases, it may exclude participation altogether.

Markets work in social space. They may be a source of conflict that prevents growth

Social factors affect market outcomes

Markets work in social as well as economic and geographic space. 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).[25]However, social networks may also exclude, as shown by the example of women's access to land. There are numerous examples of

[25] WDR 2000.

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. In such instances, the social network has turned from a public good into a 'club good' available to a few

Value chains and institutions may provide low returns to the poor

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 and those able to capture their loyalty through brands or providing retailing services. 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.

Returns to the poor depend upon whether value chains are producer or consumer driven

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. 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.

For pro-poor outcomes, ideally, markets for goods and services that matter for livelihoods should be producer driven whilst those that provide their consumption needs should be consumer driven. Further, there should be sufficient incentive within the chain to provide incentive for pro-poor growth.

Institutions can provide incentive for pro-poor outcomes

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 may help differentiate coffee, as may the area of origin or its specialist flavour. The development of rules of certification and the systems for their delivery have a vital role to play in this regard. As important as formal rules are market conventions. Thus, if in a market, the convention is to pay a price irrespective of quality or product specification, introducing formal standards may have little impact. The market needs to base exchange on the basis of the standard. Changing conventions almost always requires dialogue between stakeholders and governments.

Linked markets may help increase competition and improve outcomes for the poor

The development of linked markets may also help to reduce barriers to entry and so reduce the capture of value by processes in the value chain to the detriment of the poor. Thus, if the market power of a process that captures a high proportion of the value is to fall, it may be necessary to increase the supply of the skill or resource from which that market power derives. So, if the strength of a dominant exporter lies in contacts with customers, it may be necessary to make information on potential customers available to the smaller exporters to encourage them to compete and reduce market power.

Competition lies at the heart of making markets work for the poor. It has been shown that targeting the bottom of the pyramid represents a major opportunity for large businesses and this should help to make markets work better for the poor[26]. But for this to occur, competition must drive large businesses to address the needs of the poor. In the now celebrated case of Hindustan Lever repositioning its brand Surf to meet the needs of the poor, it was competition from Nirma, an Indian brand made for the poor that made it do so. The demand curve slopes from left to right and it makes economic sense to meet the needs of the rich first. It is competition that drives markets to meet the needs of the poor. This process of market deepening may be assisted by developing linked markets that target the needs of the poor such as SMEs and the informal sector.

The demand curve means it is attractive to serve the rich first. But competition drives the market to serve the poor

Priorities & Sequencing Institutional Change

Is it possible to develop a sequence of institutional change which starts, say with market creating institutions moves on to market regulating institutions and market stabilising institutions? The answer is qualified only. It is as important to take account of local context and the perceptions of the private sector. It may b useful to make progress on quick and easy wins first to build momentum for difficult changes.

An inter-related set of complementary measures

The measures that contribute to the three conditions for pro-poor growth are inter-linked. Thus, imposing fiscal discipline to reduce inflation and reduce crowding out of the private sector is linked closely to redirecting public expenditure towards health, education and infrastructure aimed at the poor. They are also complementary. For instance, providing infrastructure increases incentive and, if combined with improved agricultural productivity, provides the opportunity for the incomes of the rural poor to rise. Indeed, measures such as providing infrastructure and reducing the cost of doing business may contribute to bringing about all three conditions.

It may seem that the order in which the three conditions are presented here may seem to reflect priorities for sequencing and timing of change. Ensure that there is sufficient incentive for pro-poor growth to commence, ensure that competition allows resources to flow to their most productive uses so that growth is sustained and then bring about dynamic redistribution, using the resources generated by growth. In practice, though, there may be no need to work to a set order. Having established the conditions for pro-poor growth, it may then be possible to focus on broadening and sustaining growth and making markets work for the poor.

Logical sequences may not fit local contexts and the practical situation on the ground

In practice, change is never in a vacuum. Consideration needs to be given to the local context. It may be that growth commences without the policies for pro-poor growth being in place and needs to be broadened and sustained. Markets may be made to work for the poor building

[26] Raising the Bottom of the Pyramid: Strategies for Sustainable Growth, Prahalad, Freuhauf, Hart, Dec 2000.

momentum for change without addressing macro policy. What is right for a country will depend on the attitudes and policies prevailing. What is important is that all the above are considered a set of inter-related and complementary measures that need to be put into place, irrespective of sequence.

Context specific views are the key to changing behaviour

The conditions and measures described above are not absolutes, but relative, more or less rather than yes or no. More importantly, they cannot be quantified on a numerical scale and, even if some can, there are no set thresholds for when they lead to changes in behaviour. It is how the private sector perceives conditions that matters for outcomes, 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.

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.

Engagement helps identify priorities and build consensus for change.

This is where the process of engagement between government, the private sector and civil society is vital. It will help to focus attention on the conditions that matter for the private sector to deliver pro-poor growth. Some conditions, such as macro stability take time to deliver. In the interim, engagement may surface a number of other opportunities for bringing about change that will help to improve one or more of the three conditions. Engagement ensures that priorities reflect the interests of all three pillars of society and that a consensus emerges making it more likely that resistance to change will be overcome.

III. CONDITIONS FOR PRIVATE SECTOR DEVELOPMENT

Chapter II addressed the conditions for pro-poor growth. However, those are necessary but not sufficient conditions for pro-poor growth. If the private sector remains under developed and uncompetitive, those conditions may not lead to sustained pro-poor growth. The level of entrepreneurship, capabilities and productivity of the private sector matter and how they may be developed is the subject of this chapter. It addresses also the principles for providing support for private sector development in ways that do not distort markets.

Entrepreneurship & Intra-preneurship

Entrepreneurship lies at the heart of the private sector. It is the taking of risk that sets activities in motion. The processes of innovation that drive productivity and growth result from an entrepreneurial drive to find new ways to meet consumer or customer needs and organise production that will provide greater returns in terms of profit and incomes. Such entrepreneurial flair resides within individuals establishing their own businesses as well as the managers of firms (intra-preneurship). Its result is creative destruction, whereby each year, new firms are established and established ones close. Those who survive are able to create value and are more productive than the old.

Not all those engaged in running businesses are entrepreneurs. Large parts of the informal sector, for instance, are made up of individuals who have been forced into self-employment by a lack of jobs. They run 'survival businesses and would rather be employed in the formal sector. There are also individuals involved in 'life style businesses' where it is the activity that attracts the individual, not the search for profits or innovation. Farmers are part of the private sector, but not all are entrepreneurs. This is an important distinction for private sector development, as it affects the way that governments and donors support entrepreneurship and business development.

Rates of entrepreneurship depend on attitudes and the institutional regime.

Rates of entrepreneurship vary tremendously across countries. History explains some of the differences. Where economies were centrally planned or economies were predominantly subsistence, there will be little or no tradition of entrepreneurship. But that does not explain the difference between countries with similar traditions. For instance, Ukraine has only 5 SMEs per thousand population compared to 10 in Russia, despite their similar modern histories. Nor does it explain why in China and Vietnam, there has been such a strong response to regulatory change and where the rate of entrepreneurship is now higher than countries such as Bangladesh that had mixed economies.

Cultural differences are important. If the culture regards thrift and initiative as virtues, then more individuals are likely to be attracted by entrepreneurship. This is why some communities are closely associated

with commerce. But, the example of China, Vietnam shows that if the prevailing view of government and civil society are unfavourable, then the cultural background may be subsumed by the views of opinion formers. When those changed, and were accompanied by institutional changes that recognised the role of enterprise, the latent cultural disposition came to the fore.

This is why a positive attitude towards entrepreneurship on the part of government and civil society is crucial. That attitude should be expressed in concrete actions to reduce the barriers to establishing new businesses and laws that permit flexibility in forms of ownership. In Vietnam, after 1996, when government undertook such measures, over 1 million new jobs were created.

Poor Governance and bureaucracy stifles entrepreneurship

Studies of entrepreneurship[27] show that the obstacles to entrepreneurship are not only the lack of transparency in governance that increases risk and inappropriate regulations that increase the cost of doing business, but that the more bureaucratic the procedure, the less entrepreneurs wish to engage with government and the formal economy generally. They prefer informality and personal contact to bureaucratic procedure.

This is an important consideration for governments when developing institutions that affect business. Both the rules themselves, and the organisations responsible for their administration, need to design procedures and processes that minimise red tape.

The informal sector accounts for 78% of Africa's non-agricultural work force and contributes a sizeable proportion of the GDP of some countries

Informality results from high risk and cost of doing business and aversion to bureaucracy.

Governance risk and high cost of doing business in the formal sector are contributors to informality, as is aversion to bureaucracy. The cost of doing business and numbers of procedures for registering businesses are greater the poorer the country. It is the poorer countries with high costs of doing and administrative burden that also have the highest rate of informality. One of the main obstacles to formality is the threat of taxes. Setting tax thresholds too low does not make sense for tax efficiency and is a contributor to informality. The informal sector suffers high governance risk and high transaction costs. Productivity is therefore low. As it grows, it may actually reduce allocative efficiency.

Entrepreneurs frequently lack business management skills, but public provision may undermine the market

The informality and creativity that characterises entrepreneurs, however, is accompanied frequently by a lack of business management skills that may result in high rates of business failure. The rates of failure of new businesses are high the world over. Even in a developed country such as

[27] For example, Corporate Restructuring & Entrepreneurship: What can Large organisations learn from Small. Enterprise & Innovation Management Studies Vol 1, No. 1,2000,pp19-35

the UK, two thirds of new business start ups fail within the first two years. In Africa, these rates exceed 80%.

Entrepreneurs need access to business development services (BDS) to support their initial entry into business. It is at this stage though that they are least able to afford such services. Unless there are mature markets for such services, new start ups are likely to not use such services increasing the risk of business failure.

However, the public provision of these services may undermine the market for such services. As noted earlier, not all those involved in business are entrepreneurs. Thus, making available such services as a public good, without reference to demand, may simply prolong the existence of enterprises that should fail. There should be a fee charged for the service and a need for the recipient to show that the support will boost dynamic, entrepreneurial businesses. Entrepreneurs may lack business skills but is the hallmark of successful entrepreneurs that they seek out the people and service providers that they need.

Whist information and counselling may be provided free, the public provision of business development services may undermine the longer term development of private sector supply of such services.[28] The subsidised provision of these services, by using private sector providers, also creates demand dependency that is often unsustainable, demand tailing off rapidly after the subsidy ends.

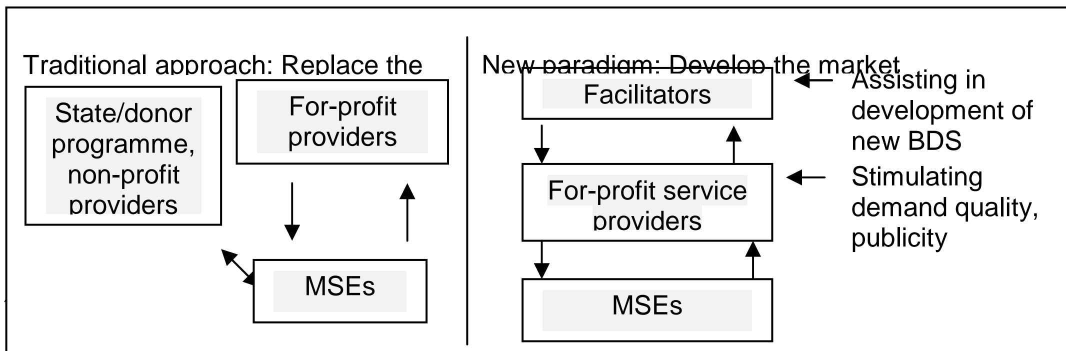
The new BDS paradigm is supply driven

The new paradigm in the provision of such services focuses on supply and its sustainability is driven by a commercial logic. The aim is to accelerate market deepening. Typically, the provision of such services is restricted to the major cities and the larger, well established businesses. With the aim of spreading the supply to cover smaller towns and smaller businesses, what is required is to use facilitators to develop curricula for training and systems of accrediting low cost providers of these services. The facilitators may then train trainers who then have an incentive to sell their training services on a commercial basis, thereby increasing the supply and making services affordable, as shown in figure 4 below.

Contrary to the popular view, there are usually a number of low cost providers of such services in most small towns and rural areas. It is the variable quality of their service and a lack of formal qualifications that prevents them being recognised by those who entrepreneurs wish to influence that prevents them being effective. Improving the quality of service and providing a recognised qualification increases supply. Demand is stimulated by the quality of the services and publicity, not subsidy. Moreover, commercial sustainability is assured from the outset.

[28] Blue Book

The Paradigm Shift in Business Development Services



Large firms can be the cradle of entrepreneurship: FDI may encourage it

Former managers make experienced entrepreneurs. But some large firms stifle enterprise

Large firms serve the purpose of developing business skills and providing management experience to would be entrepreneurs. Those establishing businesses with such experience are likely to have a greater chances of survival than those without. In Bangladesh, the very rapid expansion of the industry was enabled by mangers of the large businesses, often joint ventures with foreign investors, setting up businesses of their own.[29]In the US, a detailed study of entrepreneurship showed that 70% of new ventures were set up by employees who got their business idea whilst employed by another company.

The acceleration of growth in India after the license raj started to be dismantled was due mainly to the establishment of SMEs by former employees of large businesses. Many of India's most successful software companies fall into this category. In many developing countries, though, this does not occur, cutting off a valuable source of entrepreneurship. The employees of large businesses, knowing that influence and patronage are the basis of success in that country, and that obtaining access to finance will be difficult, choose not to take the risk of entrepreneurship.

Large firms may themselves be entrepreneurial

Large firms may themselves be entrepreneurs, taking risks by innovating products and new forms of organisation. The extent to which this occurs depends upon the culture and organisation of the business. The cultures of large firms may be based on command and control, stifling entrepreneurship, or decentralised with little hierarchy, supporting individual initiative and entrepreneurship.

This is the main role that FDI plays. Whilst FDI is several fold larger than development assistance and is a useful source of investment and support for the balance of payments, in most years, it represents a small proportion of the total investment in a country. Even in China, the world's largest recipient of FDI, it represents less than a third of total gross

[29] Unleashing Entrepreneurship: Making Business Work for the Poor. A report to the Secretary General of the UN, 2004

domestic investment. Its greater impact is likely to be the role that it plays in innovation.

Innovation & Productivity

A very large proportion of the difference between the wealth of the developed and developing countries can be explained by the differences in productivity. The diffusion of best practice and the creation of capabilities must therefore form a part of any strategy for pro-poor growth and private sector development.[30] Growth cannot be sustained and wages and incomes rise without increases in productivity.

Innovation drives productivity, driven by competition and enabled by investment

With globalisation and the ICT revolution, the conditions for diffusing best practice have never been better. But the pace of innovation does not depend upon learning alone. There must be an incentive to invest, either to capture rent through first mover advantage or through the pressure of competition. Where competitive pressure is weak, it may override the opportunity provided by first mover advantage. The Indian automobile industry is a case in point. For 40 years, whilst the world's automobile industry progressively increased its pace of innovation through the pressure of competition, protected from imports and internal competition, the Indian industry produced the same models of car! The opening up of the industry to foreign direct investment revolutionised, within a decade, an industry fossilised for four.

Protected from competition, the Indian automobile industry built the same model for over 40 years

Innovation needs investment. The investment climate and access to finance, thus play a major role in determining the pace of innovation. The development of financial instruments required for start ups and risk taking, including venture capital and credit guarantee schemes, thus have an important role to play. The establishment of stock markets are essential for increasing the availability of venture capital as they provide exit routes for equity investors. These services must be developed as part of the process of financial deepening, not as stand alone interventions on the part of governments and donors, as discussed under Access to Finance below.

Business networks help disseminate innovation and increase productivity

Productivity increases do not just come from scale. In the industry of today, focus on core competence through 'lean manufacturing' and flexibility through just in time manufacture are equally important. Modern, cellular organisation of production has, in some types of manufacturing, proved as productive as the factory line.

These developments have the potential to provide huge gains in productivity for the developing countries and those in transition. For their introduction, however, there has to be a culture in place of co-operation

[30] Ways out of Poverty: Diffusing Best Practice and Creating Capabilities, Michael Klein, Jan 2003.

between businesses. Lean manufacturing works through specialisation. The business focuses on its core competence and those processes that add the greatest value. This means that the reliance on suppliers increases. Flexibility is important, not only because it saves working capital, but because it enables the supplier to respond quickly to market trends. Co-operation between businesses allows them to meet the needs of the proliferation of market segments.

In the developing and transition countries, the culture is still for businesses to be self-sufficient. There is suspicion towards other businesses in the same industry as well as those up and down the value chain. Poor contract enforcement reinforces mistrust as the recourse to law is lengthy and expensive.

Clusters increase innovation and productivity
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 this regard. Horizontal clusters, of the type found in Italy and many developing countries, provide the basis of specialisation and flexibility, through co-operation. Vertical clusters, such as those comprising Japanese multinationals and their SME suppliers, combine the advantages of scale in marketing and assembly with the flexibility and specialisation that linking a group of SMEs provides. [31]Both types of cluster allow innovation to be disseminated quicker.

Business organisations, such as chambers of commerce and trade associations, may also serve the purpose of disseminating technology and encouraging co-operation. They may provide information and counselling to their members on a commercial basis and serve as a form of social capital encouraging bridging and linking.

Such business networks apply not only to manufacturing but also agriculture. Agri-processors are vertical clusters formed out of farmers and purchasing agents. Concerned with the risk and uncertainty and transaction costs of dealing with a large number of small farmers, these businesses have tended to work with their own captive farms or a small group of large farmers that produce under contract. Having stable and predictable rules of exchange and workable systems of contract enforcement would encourage these businesses to widen their footprint, thus benefiting the poor. Interventions that develop training and accreditation systems for purchasing agents to enable them to deal with smallholders and use informal contract enforcement systems, modelled on the new paradigm for BDS, may have an important role to play.

The structure of enterprise: the missing middle

It is recognised that some of the differences in productivity between developed and developing countries is due to the differences in firm size between them. The proportion of the work force employed in large firms is much higher in the developed countries.[32] These firms tend to have

[31] Snodgrass & Winkler, DAI, 2003

[32] Snodgrass & Biggs, 1996.

higher total factor productivity than their smaller counterparts, due to economies of scale and the quality of management.

However, the most telling difference between them is the much smaller role that medium sized enterprise play. In both types of country, the overwhelming numbers of firms are micro or small. In developing countries, these micro and small enterprises, employing less than 10 people but averaging much fewer, tend to be the main source of employment, followed by employment in large firms. What is missing is the middle sized enterprise, employing between 11-100 with the contribution of firms between 11-50 employees, most noticeable for its absence.

This has major implications for productivity. It is the growth of these businesses that provides the competitive pressure that leads to gains in productivity. It is to this size of firm that the large turn if they need to contract out supply of components and sub assemblies. It is from these firms that the next generation of the large will emerge. If they are absent, it points to problems in increasing productivity and underlying problems in the business environment.

The failure of the large numbers of small businesses to develop into medium sized businesses, shows that there are impediments in the business climate and/or accessing finance. The transition from small to medium involves a major shift in the visibility of the business to tax and regulatory agencies and the representatives of labour. If these are unsympathetic to business, there will be a preference to remain small. It is at this point of their development that firms tend to need to borrow longer term to fund their growth. Macro economic instability and the absence of long term debt instruments will hinder their growth.

By focussing on the needs of the poor, governments and donors may overlook the importance of this type of enterprise. Whist schemes to provide micro credit abound, the numbers of schemes that provide finance for this size of business is much lower and those that accommodate long term borrowing, least common of all.

Technology support institutions need to be commercially focused

Chapter II focused on the role of institutions in creating, regulating and stabilising markets to provide predictable conditions of exchange. But institutions have an important promotional role to play too. The quality of the promotional activities of these institutions has a major impact on innovation and productivity. The table below sets out the main types of market promoting institutions and their potential impact on productivity.

Type of Institution	Potential Effect on Productivity
Agricultural Research & Extension ▪ Developing productive varieties, improving technology ▪ Technology dissemination	▪ Increased agricultural productivity and productivity of agribusiness
Research & Technology Organisations, Academia ▪ Scientific research ▪ Innovation support ▪ Operational support	▪ Source of new technology, increased rate of innovation, operational advice for successful innovation, source of entrepreneurs
Standards, Quality & Measurement Organisations ▪ Regulating standards, quality ▪ Ensuring public safety Promoting standards, quality ▪ Certification	▪ Minimum product standards to develop consumer confidence, ensuring products meet international standards and quality requirements, promoting new standards that increase value addition, supporting quality, certification to meet entry conditions
Vocational & Management Training ▪ System of national vocational qualification, curricula ▪ Accrediting private sector providers ▪ Providing training for employees	▪ Increased human capital and labour productivity
Trade Facilitation Organisations ▪ Access to international markets ▪ Port & customs clearance ▪ Trade (international) promotion	▪ Increased information lower transaction costs and marketing support for trade promotion

Traditionally, these organisations were considered important symbols of national capability and were well funded. In the poorer developing country, as public expenditure has come under pressure, their funding has been reduced and many now struggle to survive. This is in contrast to the newly industrialised countries where such institutions are well funded. The effect is to reduce the support services available for innovation to increase productivity.

For the poorer developing country, strategies are required to maximise the impact of the limited funds that they can expend on these services. Such strategies need to start with the understanding that the purpose of these institutions is to promote innovation in the private sector rather than attempt to develop new technology. They cannot afford to do much original research but can act as conduits for the technology abroad by adapting it to local conditions.

Further, there is much to be gained by differentiating private from public goods. In many instances, the dissemination of new technology and advice on its use is a private good that benefits both its supplier and the user. So, much more can be done to ensure that markets deepen for their provision through helping to develop distribution systems. Whenever public organisations are used, there should be a charge levied. Public funding should be reserved for public goods such as the pre-competitive adapting of new technologies.

Access to Finance

Incomplete markets result in blockages in the flow of resources to their most productive use. A crucially important market that is often incomplete in the developing countries is the financial sector. Capital is frequently the least plentiful factor of production. The development of the financial sector is therefore correlated with the rate of growth of the economy[33]. Access to finance is a major constraint to the growth of businesses, particularly MSMEs, and is a major constraint in improving the livelihoods of the poor.

Interventions to improve finance need a systems approach

However, up to now, the response of governments and donors, whilst well intentioned, has not served to complete the market and may, in fact, have obstructed financial deepening. They have attempted to use development finance institutions and NGOs to provide finance to farmers, MSMEs and the poor and this may have prevented the development of the market in the same way as BDS projects.

Banks and other finance providers attempt to maximise the risk adjusted rate of return. They will therefore take advantage of opportunities to earn higher rates of risk adjusted return before they turn to lending to riskier MSMEs and farmers. To lend to these small borrowers, that also impose high transaction costs in relation to the volume of business, the financial sector will need to earn higher margins or spreads. The provision of low cost finance by governments and donors takes away the incentive for the private sector to serve this market. When the government runs out of funds or donor support ends, so ends the access to funds and what is more, the intervention is likely to have put back market deepening.

Instead of these well intentioned but eventually unsustainable and counter productive interventions, what is required is to take stock of the working of the financial sector as a whole and, adopting a systems approach, address the barriers to financial deepening.

Financial deepening cannot occur without sound macro policies

Inflation reduces the incentive to save, particularly long term, as do controlled interest rates. Perhaps the greatest impediment to the flow of resources to the private sector is, however, government borrowing. In Sub Saharan Africa, there are numerous instances of more than a third of the assets of the banking system comprising treasury bills. With tight

[33] Levine, Kraay, Dec 2003.

monetary policies, the effective rate of return on these instruments can be high and they are considered to be virtually risk free. If the banks can earn high rates of return risk free, the incentive to undertake riskier lending to business is diminished. Moreover, because of the lack of long term savings and the inversion of the yield curve due to monetary policy, banks also prefer to lend short term.

Without addressing these systemic problems, there is little hope for financial deepening that will lead to sustainable improvements in access to finance.

Sound institutions are a must for financial deepening

Whilst transparent and predictable rules of exchange are important for all markets, sound institutions are essential for the financial sector that works principally on trust. Lack of confidence in the financial system can have disastrous consequences as proved by the recent crisis in Argentina. The adoption of codes and standards and effective enforcement of prudential regulations is thus essential for financial deepening. Governments must themselves eschew policy directed lending to prevent the build up of non-performing loans that can undermine the soundness of the banking system, as has occurred in China and India. Equally, the regulators need to prevent the development of crony capitalism that was exposed by the Asian crisis.

Innovation is essential for financial deepening

The process of innovation, driven by competition, is essential for financial deepening. The proportion of the population with bank accounts is an important determinant of financial deepening. The reduction in the requirements for opening bank accounts and the ability to offer banking services in rural areas are important in this regard. In several African countries, the proportion of the population with a bank account is below 30%. Those excluded are usually the poor. Although they may have not had much savings, their transaction balances are important sources of finance.

New instruments for savers such as inflation proof deposits, with profit insurance, investing in higher earning corporate bonds and unit trusts may all play a role in increasing the rate of savings. Side by side new lending instruments such as the market for leasing, debentures and others may help address the constraints on accessing finance long term.

In many countries with a low ratio of bank deposits to GDP, the problem lies in concentrated banking sectors with relatively few participants, some government owned, which makes for low competitive intensity. In other cases, whilst the country may be over banked, the development of the financial sector may be biased towards business and not sufficiently focused on offering personal financial services. This is the case in many transition countries. In both instances, liberalising the participation of foreign banks may introduce the right type of competition to encourage innovation.

Wholesale markets provide the link to the poor

A common problem in developing countries is that the financial system has poor linkages between product segments. Notably, the community banks and micro finance institutions (MFIs) at the bottom of the system have no way of tapping funds from the commercial banks. Thus a disjoint can occur that prevents funds from reaching their most productive use. By lending directly to MFIs, donor programmes may do little to address this market failure.

What is required is to develop wholesale markets for finance and enable the MFIs and community banks to be credit rated. Unlike the commercial banks and public development finance institutions, these institutions have the low transaction costs to serve MSMEs and farmers. A system of credit rating for these institutions would provide them with an incentive to improve their financial management and adopt prudential regulations and enable them to borrow from the commercial banking. Markets may be developed for training and accrediting service providers to advise the MFIs and community banks on how to improve financial management.

The structure of interest rates should provide the commercial rationale that makes such an intervention sustainable. The commercial banks should be able to earn higher returns than treasury bills, the community banks and MFIs charge a reasonable spread on top with the borrower paying a prime rate as a result of the small size and high risk. There are many studies that report that what matters is access to finance on appropriate terms (low collateral requirements) rather than the cost of finance.

In India, ICICI has become a wholesale finance provider to MFIS provided they meet

Delivering Pro-Poor Change

For achieving rapid pro-poor growth through the private sector, perhaps the really important issue is not what needs to be done but how to bring about change. As Douglas North pointed out, we have known for sometime what conditions are required for bringing about growth and poverty reduction, what we have not known is how to bring about such conditions. This is a particular challenge when dealing with multidimensional issues of poverty reduction which involve governments, politicians, a disparate private sector made up of many interest groups and the range of interests that civil society encompasses.

In the past, development agencies have attempted to drive change through the technical merits of their intervention and even resorted to conditionality. It is now recognised[34] that change must be internally driven with the development partners playing an enabling role.

A process of engagement helps to reach consensus

The agenda for bringing about conditions for pro-poor growth and private sector development is huge. It involves a continuous process of experimenting with institutional change and monitoring outcomes through participatory learning so that the intended beneficiaries can feed back on

[34] Stiglitz, New Development Paradigm

how effective the change has been and what should be done to improve the process to achieve better outcomes in the future.

The intended beneficiaries include all three parts of society: government, the private sector and civil society. Therefore, the process must involve engagement between them on priorities and sequencing as well as the appropriate institutions that will bring about the necessary change. They must also be involved in monitoring outcomes and participatory learning to ensure that the lessons of experimentation are digested and acted on.

In some countries, the process of engagement between the three will be part of the everyday processes of government and politics. In others, the channels for such engagement may be weak and/or not enable a process of constructive dialogue. In the latter case, donors may play a useful role in facilitating engagement.

Building issue based constituencies for change

The key barrier to change is that, when threatened, powerful vested interest may block change[35]. For instance, whilst the private sector and civil society may agree that reducing the cost of doing business is desirable, the bureaucrats may oppose reducing the number of procedures and making them more transparent as it will lose them influence.

Frequently, there will be opposed interest groups within each of government, private sector and civil society. It cannot be assumed that all the private sector will support liberalisation and the development of sound institutions. Parts of the private sector may oppose reducing barriers to entry or lowering protection and those in receipt of subsidy will almost certainly resist its removal. Equally, it cannot be assumed that civil society will always support change that is in interest of poverty reduction. Parts of civil society may resist flexible labour markets and the removal of subsidy.

What is required is to build issue based constituencies that support change. These constituencies can be assisted to provide the evidence for change and engage in dialogue with those opposed to change. They may need to provide technical solutions to overcome resistance to change and/or develop compromises that will help overcome resistance. Thus reducing procedures may be acceptable to the bureaucrats only if the fees for registration are increased. The process of change is above all pragmatic.

Change the system without becoming part of the system

The sections on BDS and Access to Finance showed how governments and donors, when trying to assist pro-poor growth, may end up distorting or delaying the process of market deepening. There is a need to adopt a systemic approach to change when addressing market outcomes that involve the private sector, as illustrated under Access to Finance.

[35] DFID, Drivers of Change

Systemic change requires a combination of institutional change, formal and informal, to make the rules of the game favourable for pro-poor outcomes. This may involve change in market creating, market regulating, market stabilising and market promoting institutions to reduce risk and transaction costs, address market failure and missing or incomplete markets. It is likely to also involve addressing pressure points in the value chain through conventions and business support services.

In delivering such change, governments and 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 alters the system and makes it reliant on continued intervention. This may be acceptable is government is the intervener. It is almost never so when donors and development agencies do so on grounds of sustainability.