Poverty-Reducing Growth Strategy in Poor Countries*

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Abstract

This paper synthesizes and develops research undertaken by participants in The North-South Institute project, "Macroeconomic policy choices for growth and poverty reduction" in low-income developing countries.[1] The project analysed the features of poverty and growth in seven poor countries of varying circumstances and proposed macroeconomic and growth policies for poverty reduction for them. The research was guided by the question: "How does poverty inform growth strategy?"

Our research provides evidence of the channels through which growth and distribution or poverty processes depend on each other and respond to policy together. We encapsulate the messages of these case studies in the following six propositions, discussed at length in the paper: i) macroeconomic stability reduces poverty; ii) land re-distribution enhances growth; iii) income poverty traps constrain growth; iv) urban-rural growth disparities drive income inequality; v) regional poverty traps resist growth; and vi) key growth policies can aggravate poverty gaps.

The propositions suggest growth policies that may be either of two types in terms of impact on growth and distribution. They have the potential to enhance both growth

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1 The project research papers are listed on the last page of this document. The papers may be obtained directly from the authors (contact information is included in the list). Shorter and non-technical versions of the papers are available from The North-South Institute website at www.nsi-ins.ca.

and distribution (win-win) or to enhance growth while aggravating income gaps or vice versa (win-lose).

Resumen•••

Este documento sintetiza y desarrolla las investigaciones realizadas por los participantes del proyecto "Opciones de política macroeconómica para el crecimiento y reducción de la pobreza", desarrollado por el North-South Institute para los países en desarrollo y de bajos ingresos.[2] El proyecto analiza las características del crecimiento y de la pobreza en siete países pobres con distintas condiciones y políticas macroeconómicas para el crecimiento y reducción de la pobreza diferentes. La investigación se enmarcó en la pregunta: "¿En qué medida la pobreza puede ayudar a encontrar la estrategia de crecimiento?"

Nuestra investigación provee evidencia de los canales a través de los cuales el crecimiento, la distribución o los procesos de pobreza dependen el uno del otro de manera conjunta a las políticas. Hemos englobado los mensajes de cada uno de los casos de estudio en las siguientes seis proposiciones discutidas a lo largo de este documento: i) la estabilidad macroeconómica reduce la pobreza; ii) la redistribución de la tierra aumenta el crecimiento; iii) las trampas de la pobreza e ingreso restringen el crecimiento; iv) las diferencias entre sectores urbanos y rurales llevan a una desigualdad del ingreso; v) las trampas regionales de la pobreza niegan el crecimiento; y vi) las principales políticas de crecimiento pueden agravar las brechas de pobreza.

Las proposiciones sugieren que las políticas de crecimiento podrían ser de dos tipos en términos del impacto sobre la distribución y el crecimiento. Ellas tienen el potencial de, o bien aumentar tanto el crecimiento como la distribución (win-win), o bien incrementar sólo el crecimiento mientras empeora la brecha del ingreso y viceversa (win-lose).

••• La traducción del resumen al español es responsabilidad de los editores de la Revista Latinoamericana de Desarrollo Económico.

2 Los documentos de investigación del proyecto están listados en la última página de este documento, los mismos que pueden ser obtenidos directamente de los autores (las direcciones se incluyen en la lista). Versiones resumidas y no técnicas de los documentos están disponibles en el North-South Institute: www.nsi.ins.ca

1. Introduction

Deep poverty appears everywhere, in both rich industrialized and poor agricultural countries. Poverty in poor countries is widespread, though, reaching up to 70 percent of the population. It is so pervasive as to affect macroeconomic growth and development, as well as to be affected by them. The scale of poverty in poor and middle-income countries is often associated with gross inequality of income distribution, which also affects macroeconomic growth and development. Most poor countries, especially in sub-Saharan Africa, are among the most unequal countries in the world.

Poverty reduction, a better income distribution and economic growth are all goals of development in poor countries. These goals, however, do not behave independently of each other. Growth usually reduces overall poverty, or equally, poverty reduction usually enhances growth. This principle is reflected in the formal development strategies of most poor countries, as stated in their "Poverty Reduction Strategy Papers." PRSPs emphasize growth as the main way to halve poverty by 2015, which is the first Millennium Development Goal. It would be more accurate to call PRSPs "Growth Strategy for Poverty Reduction Papers".

While growth tends to reduce poverty on the whole, it is about as often associated with rising as with falling equality in the distribution of income in the short- and medium-terms, when policy reform is most effective for growth. In the long-term, when a country's institutions matter most for growth, a high level of entrenched inequality constrains growth and poverty reduction.

Given these relationships, how should growth strategy respond to the macroeconomic scale of poverty and inequality in poor countries? To answer we posit two principles. The first is as follows.

Growth and Distribution both are Means of Poverty Reduction

Growth and distribution are distinct goals of development strategy, but they are also both instruments for poverty reduction. We know from experience that poverty falls faster with economic growth when income is distributed more equally. A given rate of growth can be associated with a variety of rates of decline of poverty in different

countries, depending on the current distribution of income. Similarly, within a country the responsiveness of poverty to growth varies across sectors and changes over time with differences in the distribution of income.

For example, the impact effect of growth on poverty is higher in Tanzania than it is in Senegal. Income is distributed more equally in Tanzania, which has a Gini index of 0.35, than in Senegal, with a Gini of 0.48.[3] Within Senegal, the impact effect of growth is higher in the rural (Gini index 0.33) than in the urban sector (Gini 0.47). When China started its economic reforms in the late 1970s it had a relatively uniform distribution of income (a rural Gini index of 0.21 in 1978), as do most recently centrally planned economies such as Vietnam and Albania. By 1990 the rural Gini index in China had risen to 0.38, and it continued to rise to 0.46 in 1998. China's rapid growth coincided with fast poverty reduction, but also with rapidly diverging incomes, largely along regional lines. Today China is one of the most unequal countries in the world and poverty is declining less and less in response to growth (Yao *et al.*, 2004).

For these reasons poor people do not care only about economic growth. They also care about how the income generated by growth is distributed. When development strategy is chosen collectively, as in the PRSPs, what poor people think matters. The recent elections in India illustrate the point. In May 2004 "India's electorate ... stunned both the world and itself by throwing the ... government out of office in the middle of one of the country's strongest periods of economic expansion" (*Financial Times*, 14 May 2004). Although net poverty was falling, the speed of the fall among the two-thirds of Indians living and working in the rural economy was not commensurate with the rate of overall growth.

The second principle to guide the way poverty affects growth strategy is as follows.

Growth and Distribution are Inter-Dependent Processes

The short- to medium-term relationship between growth and distribution is unpredictable because they are both affected by other factors, such as macroeconomic constraints, economic structure and patterns of household production and consumption.

3 The Gini index takes values from zero to one, with a higher value indicating a less equal distribution.

Policy reforms that change these factors yield one of a variety of combinations of growth and distribution outcomes. In general there are no purely growth or re-distributive strategies.

Lundberg and Squire (2003) provide direct cross-country evidence that most growth policies also help to determine the distribution of income and vice versa. The research reviewed here (the appendix lists our background papers) provides related evidence from seven very different poor countries of the channels through which growth and distribution or poverty processes depend on each other and respond to policy together. We encapsulate the messages of these case studies in the following six propositions.

- macroeconomic stability reduces poverty
- land re-distribution enhances growth
- income poverty traps constrain growth
- urban-rural growth disparities drive income inequality
- regional poverty traps resist growth
- key growth policies can aggravate poverty gaps

The first three propositions support a positive association between growth and income distribution or poverty outcomes. The last three support a negative association between the two. The opposing combinations are consistent because they refer to disaggregated channels of transmission from policy reform rather than to a single aggregated relationship between growth and distribution outcomes. Depending on the policy reform or on which channel dominates, different countries may show different combinations of growth and distribution outcomes or of growth and poverty responses, or the same country may show different combinations over time.

Let us accept these two guiding principles, that growth and distribution are both means of poverty reduction and that the two depend on each other. We may now point to the conclusions we will reach, following discussion of these six propositions, about how the nature of poverty in poor countries should affect the choice of growth strategy.

If growth and distribution were independent processes, we could pursue the growth, distribution, and poverty reduction objectives independently. Following purely technical

criteria we would combine growth and re-distributive policies into a development strategy that achieves the fastest rates of growth and poverty reduction.

Since growth and distribution are inter-dependent, in general maximizing the growth rate is not equivalent to maximizing the rate of poverty reduction. The positive correlation between growth and poverty reduction does not always extend to fast growth and rapid poverty reduction. For example, the state of Kerala, with a population of 30 million people, has one of the fastest rates of income poverty reduction in India, and some of the most advanced indicators of human welfare, exceeding those in China. Yet it has an average growth rate below that of many other Indian states and much lower than that of China (Sen, 2004: 64). To the extent this is a structural trade-off in outcomes, we are forced to make political choices between the growth, distribution and poverty reduction objectives of development.

Since we cannot have a purely technical prescription for poverty reduction strategy, instead of identifying optimal policies we characterize the nature of policy choices to be made when designing PRSPs. For example, we find evidence from Vietnam and Malawi that land reform both improves the distribution of income and enhances growth, with compound effect on poverty. This is a 'win-win' policy which is not emphasized in current PRSPs. But land reform may not achieve as fast a rate of growth as other less benign policies, and it does not seem able to sustain growth indefinitely.

In contrast, Sri Lanka's analysis of agricultural trade liberalisation, combined with experience elsewhere, suggests that trade liberalisation is a 'win-lose' policy. Although it is likely to increase growth and reduce poverty overall, it will increase poverty in certain agricultural regions and may worsen the overall distribution of income over time. This is especially worrisome if income is currently very unequally distributed, as the poverty impact of possibly rapid growth will be small and get smaller.

Designing development strategy in PRSPs is not simply a matter of fine-tuning a globally applicable growth policy so as to reduce transition costs for the poor. It is about selecting growth and distribution policies in context, politically balancing competing objectives and technically achieving the best possible terms from unavoidable policy trade-offs. This makes a coherent macroeconomic growth and poverty reduction strategy.

2. Poverty Features and PRSP Growth Strategy

The share of the population that is poor in poor countries is usually very high, often more than half and sometimes over 80 percent (Table 1). Poverty in poor countries affects the behaviour of the entire economy and the course of development. Poverty overall is, in turn, affected by macroeconomic outcomes. It is not surprising, then, that all of the PRSPs produced by poor countries identify economic growth as the key way to reduce poverty (Gottschalk[4]). Many of them, in fact, see growth as the only way to reduce poverty on a broad scale, sufficient for the first Millennium Development Goal (MDG).

Table 1
Poverty Incidence in Selected Poor Countries

	Population living below the poverty line		Population living below $1/day (%)[1]
	Year	%	
Bolivia	1999	63.0	14.4
Burkina Faso	1998	45.3	61.2
Ethiopia	1999/2000	44.0	81.9
Honduras	1999	66.0	23.8
Malawi	1998	65.3	41.7
Mauritania	1996	50.0	28.6
Mozambique	1996/1997	69.4	37.9
Nicaragua	1998	47.9	82.3
Niger	1993	63.0	61.4
Rwanda	2001	60.3	35.7
Senegal	2001	53.9	26.3
Tanzania	n.a.	n.a.	19.9
Uganda	1997	44.0	82.2
Vietnam	1998	37.4	17.7
Zambia	1998	72.9	63.7

Source: Gottschalk, draft background paper. The data are from the countries' PRSPs, based on national surveys.

1 Data are from the Human Development Report 2003 of the United Nations Development Program. The data are the most recent available.

4 We refer to our background research papers by author alone. The background papers are listed in the appendix.

> *All PRSPs and I-PRSPs ... give absolute priority to economic growth as a means of poverty reduction.... Surprisingly, only a quarter of these PRSPs and I-PRSPs use the term 'pro-poor growth' or contain statements about ensuring that growth is equitably distributed, suggesting a continuing faith in the power of growth alone to reduce poverty without significant attention to equity* (Marcus and Wilkinson, 2002: 9).

Gottschalk reports that the main elements of the proposed growth strategies are three: i) investment in human capital and economic and social infrastructure; ii) macroeconomic stability; and iii) structural and institutional reform, mainly labour, tax, financial and trade reforms. Some of the PRSPs do say that growth should be spread out through the economy, so that the poor are better placed to participate. To accomplish this, they promise to prioritise agricultural development, since within poor countries 70 percent of the poor live in rural areas and most work in agriculture.

However, the PRSPs do not elaborate a growth strategy, much less an agricultural growth strategy, based on an analysis of the features of poverty in the country. The first official World Bank and IMF review of PRSPs found that all of them include a poverty profile, but none uses it to help determine macroeconomic development policies and most do not explain how PRSP policies will reduce poverty (IDA and IMF, 2002, p. 32). The PRSPs tend to simply present growth targets for the economy as a whole without substantial discussion of how they derive from policy reforms. The growth targets appear to be influenced by what is required to meet the MDG poverty target, based on estimates of the responsiveness of poverty to growth. The targets are associated with a required private investment rate derived from an assumed incremental capital-output ratio.

In many cases the targeted investment and growth rates are unrealistically high. Nearly all are substantially above historical growth rates (Tables 2 and 3). Even so, Ki shows for Senegal that, given badly distributed income (one of the worst in the world), the MDG poverty target will not be met. Hanmer *et al.* (1999) find that without re-distributive policy sub-Saharan Africa will need to grow by 8 percent per year until 2015 to reach MDG poverty targets, faster than the already ambitious PRSP targets.

PRSP growth targets are set for the economy as a whole, rather than separately for the manufacturing and agricultural sectors as would befit an effort to make growth

broadly based. In poor countries, although most of the population and most of the poor live in rural areas, agriculture contributes only 27 percent to the economy (17 percent in sub-Saharan Africa). Agricultural productivity is very low compared to that of manufacturing and services. From 1980 to 1998 agricultural output per worker rose by 1.6 percent per year for all poor countries, but in sub-Saharan Africa it declined by 0.6 percent per year (World Bank, 2000:16).

Most poor people live in South Asia, particularly in China and India, but most of the poor countries are in sub-Saharan Africa. These countries are among the most unequal in the world in terms of the distribution of income, as a region second only to Latin America (Chart 1). Yet PRSPs have little to say about re-distributive policy or about the implications of the distribution of income for growth strategy.

Table 2
GDP Growth in the 1990s and the PRSP Growth Targets (%)

	1990-99	1995-99	2000	Target
Bolivia	4.0	3.9	2.4	5.0-5.5
Burkina Faso	4.7	5.9	2.2	7.0-8.0
Ethiopia	3.7	5.4	5.4	7.0
Honduras	2.8	2.8	4.8	5.0-6.0
Malawi	4.2	7.0	1.7	5.0
Mauritania	3.4	4.2	5.2	8.0
Mozambique	5.7	8.5	1.6	7.0
Nicaragua	2.9	5.1	4.3	4.5
Niger	1.9	3.7	0.1	4.0
Rwanda	2.1	15.7	5.6	7.0
Senegal	3.3	5.3	5.6	7.0-8.0
Tanzania	3.1	3.8	5.1	5.0-6.0
Uganda	6.9	7.7	3.5	7.0
Vietnam	7.4	7.5	5.5	8.0
Zambia	0.3	1.5	3.5	4.0

Source: World Development Indicators and PRSP documents, in Gottschalk.

Table 3
Level of Investment Needed to Meet the Growth Targets

	Investment/GDP (average 1996-2000)	Investment/GDP (year 2000)	Investment/GDP (required for growth target[1])
Bolivia	19.1	17.2	23.0-25.4
Burkina Faso	27.6	25.5	32.2-36-8
Ethiopia	16.5	15.3	18.4
Honduras	32.4	32.5	37.3-44.8
Malawi	12.9	12.5	15.5
Mauritania	20.6	30.3	35.4
Mozambique	28.6	39.6	17.6
Nicaragua	30.8[2]	24.22[3]	25.4
Niger	10.6	10.8	10.7[4]
Rwanda	15.5	17.5	12.6
Senegal	18.8	19.8	23.9-27.3
Tanzania	15.7	17.6	20.1-24.1
Uganda	17.7	19.8	22.3
Vietnam	28.5	29.6	35.7
Zambia	16.0	18.7	19.5

Source: World Development Indicators, in Gottschalk.

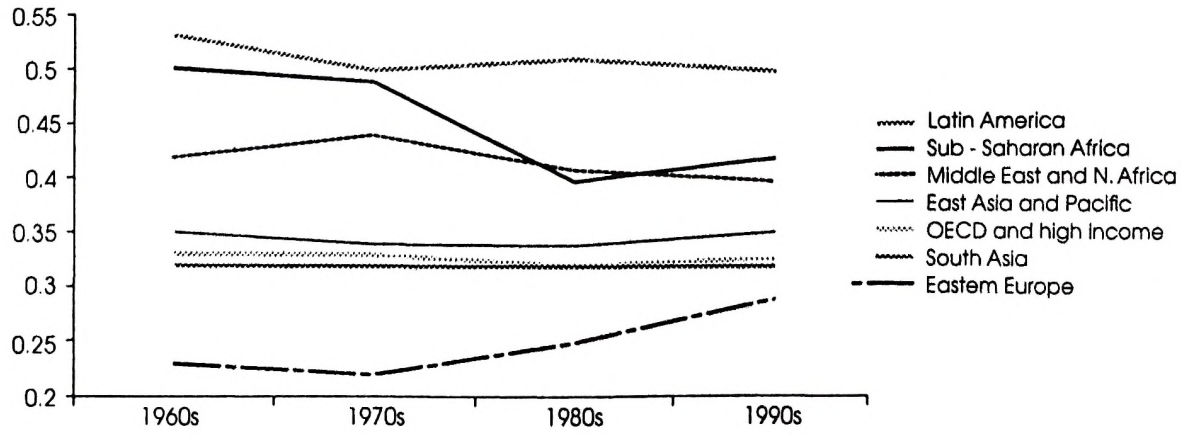
1 Calculated using the countries' average incremental-capital output ratios (ICOR) over the 1996-2000 period, with years marked by deep recession (often caused by exogenous shocks) excluded.

2 Average 1996-1998.

3 Refers to the year 1998.

4 ICOR over the 1995-1998 period.

Figure 1: Regional Gini Coefficients
(Median values; a larger coefficient indicates a less equal distribution)



Source: Based on data from Deininger and Squire (1998), re-produced in Bigsten and Shimeles (2003: 2).

3. Propositions about Links between Growth, Distribution and Poverty

The eight research papers reviewed here identify salient features of poverty and income distribution in each country and propose policies to address them while promoting economic growth. These papers recognize the inter-dependence of growth and distribution dynamics and the contribution of each to poverty reduction. The research emphasizes the relevance of high or rising inequality to poverty reduction strategy, and the need to go beyond merely setting aggregate growth targets.

The country research makes six key propositions concerning connections between growth, income distribution and poverty, re-produced here from our introduction.

- macroeconomic stability reduces poverty
- land re-distribution enhances growth
- income poverty traps constrain growth
- urban-rural growth disparities drive income inequality
- regional poverty traps resist growth
- key growth policies can aggravate poverty gaps

These are not the usual observations on correlations between aggregate outcomes. They are correlations or causal relationships between growth policies and distribution or poverty policies or features. These relationships arise primarily from the economic structure of low-income developing countries and the tendency of growth to concentrate regionally or locally. The propositions suggest that growth policies may be either of two types in terms of impact on growth and distribution. They may enhance both growth and distribution (win-win) or they may enhance growth while aggravating income gaps (win-lose).

3.1. Macroeconomic Stability Reduces Poverty

Current growth strategies presented in the PRSPs emphasize macroeconomic stability, along with private investment and structural reforms (Gottschalk). The way to achieve macroeconomic stability, according to the PRSP documents, is nearly always to restrain public spending and maintain price stability.

This approach is particularly appropriate when using economic growth as a means of poverty reduction. There is persuasive evidence not only that price stability is needed for growth, but that it reduces poverty directly, adding to its indirect contribution to poverty reduction through growth. We will briefly review this evidence and the transmission mechanisms later.

Gottschalk points out that demand stability is also an important part of macroeconomic stability, but is neglected in the PRSPs. Demand stability is particularly relevant to poor countries since they tend to have narrow producing and exporting bases and increasingly open trade regimes. Thus they are vulnerable to natural disasters and external shocks. The latter include a fall of the terms of trade (fall of the price of the primary commodity export or rise in the price of imported fuel or imported manufacturing materials) or of foreign direct investment or tourism, or unstable flows of foreign assistance. Since most poor countries have small economies external shocks have a large domestic impact. Poverty in poor countries nearly always rises following a negative external shock, and tends not to fall to pre-shock levels with the recovery of the overall economy.

Gottschalk calls for more attention to fiscal and monetary flexibility in the PRSPs, without sacrificing price stability, to deal with external shocks. Poor countries should be able to use countercyclical macroeconomic policy to maintain demand stability.

3.2. Land Re-Distribution Enhances Growth

Le *et al.* writing of Vietnam note that the main policy reform leading to a halving of poverty in less than a decade was de-collectivization of agricultural production (see also World Bank, 2001). This was effectively land reform, in which private access rights were more or less evenly distributed among households. The reform initiated a period of fast agricultural growth epitomized by the transformation of Vietnam from a rice importer before 1989 to the world's second or third largest rice exporter thereafter.

Chirwa takes up the theme of land reform for Malawi, identifying the small size of household land holdings as a constraint on growth and poverty reduction. Malawi had four decades of agriculture-led development, which is again emphasized in the current

PRSP. Through most of those decades Malawi experienced erratic growth and persistent and, recently, rising poverty. Agricultural development as such does not ensure either rapid growth or rapid poverty reduction (see also Osmani, 2000).

Malawi has a dual agricultural system comprising large-scale estates, most producing tobacco for export, and smallholder household farms growing food for domestic consumption. Through most of the past four decades agricultural policy favoured the estates at the expense of the smallholders. This was achieved by regulating production of crops and prices for marketing agents and producers. The policy held despite a preponderance of smallholder farms accounting for more than 80 percent of households.

In the mid-1980s Malawi began a series of agricultural reforms, mostly various de-regulations, leading to a more balanced treatment of smallholders and estates. For example, liberalisation of tobacco production in 1990 led to an increase in smallholders growing tobacco, such that they now account for 70 percent of production. Yet most smallholders continue to grow food alone and productivity remains low.

Currently the 1.8-2.0 million smallholder farmers who account for 84 percent of value-added in agriculture own on average only one hectare of land. Chirwa provides evidence that agricultural productivity is positively associated with the size of land holdings, at least where initial land holdings are very small. He contends that the absence of land reform inhibited the effect of the many other reforms pursued since the mid-1980s. Chirwa shows that increasing household land size marginally will also directly reduce poverty. Land reform is physically feasible, since two-thirds of the country's total land area is under customary tenure and many of the tobacco estates are abandoned.

3.3. Income Poverty Traps Constrain Growth

Mercado *et al.* on Bolivia emphasize the difference between static and dynamic poverty at the household level in poor countries. Static poverty refers to a situation where the same households are poor in perpetuity. Dynamic poverty refers to a situation where different households are poor at different times, although the overall level of poverty in the country may not change.

The difference between static poverty or an income poverty trap, which Mercado *et al.* refer to as 'social immobility', and dynamic poverty matters for policy and for poverty and growth. If poverty is dynamic or transitory for each household, the government can address it by providing various forms of insurance, such as unemployment benefits, and borrowing facilities so that households may maintain a steady level of consumption through both good and bad times.

If poverty is static, poverty policy is essentially re-distributive, and permanently and uni-directionally so. Further, static poverty or social immobility increases the overall level of poverty and constrains economic growth. Poor households have no incentive to invest in education, long-term crops or equipment if they have no chance of escaping poverty anyway. The expectation that effort and expense will not return a benefit is self-fulfilling as it reduces the amount of effort or investment. They will also not be able to borrow to invest. The overall level of investment in the economy is then below potential, but in addition productivity for the given level of investment is reduced by the waste of talent, ideas, and entrepreneurship latent in poor households.

Mercado *et al.* produce evidence that social immobility in Bolivia is exceptionally high, even compared to its neighbours. They also show that social immobility is negatively correlated with growth in 18 countries in Latin America.

A key mechanism behind social immobility is education across generations. In Bolivia and elsewhere in Latin America family background affects the education outcomes of young people. That is, a person's quality of education is determined largely by the education and income of the parents. Although almost 95 percent of 7-13 year olds attend school, the quality of public education in Bolivia is very low relative to other Latin American countries, and the gap between public and private school students is among the highest in the region.

3.4 Urban-Rural Growth Disparities Drive Income Inequality

In most poor countries the distribution of income tends to be more uniform in the rural than in the urban sector. Thus, for a given sectoral rate of growth, poverty will fall faster in rural areas, both relative to the initial sector poverty rates and in absolute

numbers of people. Ki demonstrates this for Senegal, and it is the rationale for proposing a strategy of agricultural growth in many countries' PRSPs.

Wangwe observes that the agricultural sector in Tanzania is large, accounting for 48 percent of the economy. The agricultural growth rate since 1986 has been a fast 3.9 percent and, because of the size of the sector, income is fairly evenly distributed, as indicated by an overall Gini coefficient of 0.35.

By contrast, Ki reports that in Senegal primary activities, most of which are in agriculture, contribute only 19 percent to the economy. Moreover, the primary sector is growing at only 2.2 percent per year. Partly as a result, overall income is very unevenly distributed in Senegal, which has an overall Gini coefficient of 0.48.

In Vietnam fast growth since the early 1990s originated in agriculture and was accompanied by fast poverty reduction across the economy. However, Le *et al.* find that recently the households that benefit most from growth have well-educated members working in the urban services sector. Those benefiting least are in remote regions, are ethnic minorities or work in agriculture. The authors also report that overall inequality is rising with growth, as the rural-urban income gap widens.

In a similar vein, Osmani (2000: 115) points out that mainland China's rapid economic growth since the mid-1980s is characterized by rising inequality, with the result that the rate of poverty reduction has fallen drastically. The rise in inequality essentially reflects urban-rural or regional disparities, as rural regions with backward infrastructure are increasingly left behind.

3.5 Regional Poverty Traps Resist Growth

Regional poverty traps are defined by geography as distinct from income poverty traps defined by economic class. Regional traps occur in some poor countries even when the economy as a whole is growing steadily, income is evenly distributed or overall poverty in the country is falling. They exist, for example, in Albania and Vietnam which have all three advantageous features. Poverty traps are usually located in remote areas and may affect ethnic minorities most.

Regional poverty traps in poor countries may be large in area and can affect the course of the entire economy. In the remote mountainous regions of north and northeast Albania, where the main industry is mining, nearly half the population is poor, about double the poverty rate for the whole country. In the absence of a strong government response to the discrepancy, Mancellari and Hida say that there began a massive emigration from the country as well as an internal migration from the remote regions to the cities. The emigration has some positive benefit in the form of large remittances, reaching at least 15 percent of GDP in 2001. The internal migration is natural, given that, as reported by Mancellari and Hida, most of the benefits of growth go to the cities, while rural and remote areas are left behind.

In Vietnam, poverty had been halved by 2002, but the poverty rate remains relatively high at 30 percent, and is proving harder to address through growth than before. This is partly because of the persistence of poverty in remote regions, many of which are inhabited by ethnic minorities. In the northwest of the country the poverty rate is 70 percent, and generally the dispersion in poverty rates across the country is large. Le *et al.* find in regression analysis that regionalism and ethnicity partly explain differences in provincial poverty rates.

3.6 Key Growth Policies can Aggravate Poverty Gaps

It is hard to generalize about growth policies, to be confident that a particular policy will initiate and sustain growth in most poor countries. However, the policy or policy regime that comes closest to generating such confidence is "openness", comprising trade liberalisation and a realistic or depreciated real exchange rate (Rodrik, 2004). Jayanetti and Tilakaratna advocate trade liberalisation for Sri Lanka, arguing that it is necessary to achieve the growth that is the primary means of poverty reduction. Their paper focuses on the short-term impact effect of liberalising trade in agriculture, specifically in rice. They show through a simulation exercise that this will raise average incomes, improve the distribution of income and reduce poverty. These results follow naturally from their observations that Sri Lanka is a net importer of rice, and that the poor spend a larger share of their incomes on rice than others do.

Sri Lanka produces most of the rice it consumes, though, and this contributes 20 percent to the economy. Jayanetti and Tilakaratna note that rice is produced throughout

the country, but some districts depend almost wholly on it for income and most of those who grow it are poor. They show that rice producers across the country and rice-producing districts in particular will be worse off after liberalisation. Indeed, this is the reason the government was not willing or able to fully liberalise rice imports before. The government tried to have it both ways, appeasing rice consumers and producers alike with frequent and ad hoc changes to tariffs and inconsistent regulation of production and importation.

Thus, although liberalising rice imports would likely improve the distribution of income and reduce the overall poverty rate, it was prevented by a probable widening of the gap between poor rice consumers and poor rice producers. Jayanetti and Tilakaratna therefore call for combining agricultural trade liberalisation with compensation for rice producers.

The analysis and conclusions of Jayanetti and Tilakaratna closely follow the approach to trade liberalisation advocated by Winters *et al.* (2002). That is that trade liberalisation is necessary but should be accompanied by a targeted social safety net to protect the poor from adjustment costs and to buttress political support for it. This is appropriate for growth policy that improves aggregate welfare with multifarious impacts on poverty at local and regional levels. However, while trade liberalisation may tend to promote growth and reduce poverty in poor countries, in many circumstances it also tends to aggravate income as well as poverty gaps. This undermines a key development objective and overall welfare and compromises the impact of growth on aggregate poverty, especially when incomes are currently badly distributed. In such circumstances the role of trade liberalisation in growth strategy at all is questionable.

4. Policy Choices

The preceding six propositions testify to the entanglement of growth and distribution processes in poor countries. So it is that few macroeconomic or development policies can be identified as purely growth or purely re-distributive policies. As we shall see, most policies affect both, and therefore, when considering the impact of policy on poverty, one must trace out the channels of transmission through both growth and distribution.

We emphasized in our introduction that growth, distribution and poverty are independent objectives of development, even if they are inter-dependent processes. The goal of growth strategy, then, is not necessarily to maximize the rate of growth or the uniformity of the distribution of income or the rate of poverty reduction. The desired combination of these three objectives is decided by the individual country through social and political processes. Keeping to this principle, we do not try to elicit from the preceding propositions and external evidence specific policies to be included in growth strategy. Rather we look for policy choices and combinations available to each poor country as it designs its own growth strategy.

Closely following the propositions we find six development policy options, grouped according to their anticipated growth and distribution outcomes, as suggested by our research and other evidence. Classifying growth policies this way helps clarify the issues and choices involved in designing a growth strategy. However, while not arbitrary, our selection and allocation of policies should not be taken too seriously. Exceptions can be cited in many cases, depending on the context.

Three of our policy options tend to enhance growth and narrow income gaps. These are potentially 'win-win' policies and they include:

- price and demand stability
- land reform
- agricultural productivity growth

Two other policy options tend to enhance growth while aggravating income gaps, or to narrow income gaps at the expense of the rate of growth. These are potentially 'win-lose' policies:

- public investment
- trade liberalisation

Another important policy option is not easy to categorize as either win-win or win-lose, although it will very likely have such characteristics. It is:

- public education

There is a strong pre-disposition among many analysts and development professionals, including our own researchers, to believe that public education is a win-win policy. So far, though, evidence from poor countries favours the view that public education tends to improve income distribution while reducing, or at least not helping, the growth rate.

4.1 Win-Win Policies

These are the desirables, the policies that should be, but are not always, emphasized in development strategy in PRSPs. They are efficient in terms of contributing to all of the development objectives. However, individually they do not necessarily yield maximum growth or maximum poverty reduction rates.

Price and Demand Stability

Conventional wisdom and much evidence has it that macroeconomic stability is necessary for growth, as noted above (see also Rodrik, 2004). This usually refers to price stability, but Gottschalk contends that it also applies to demand stability, which in the face of external shocks requires countercyclical fiscal policy. There is also evidence that price and demand stability improve the distribution of income and reduce poverty directly, in addition to the indirect effect through growth.

Lundberg and Squire (2003) test a number of conventional policies for joint determination of growth and distribution, using cross-country regression analysis. They find that controlling inflation both increases the rate of growth and improves the distribution of income. Cashin (2001) reviews evidence on the impact of inflation on poverty and finds a consistently positive relationship between the two.

The link between inflation and inequality or poverty operates primarily through the behaviour of real wages, on which the poor rely. Real wages tend to fall as inflation rises. However, the effect is non-linear. Reducing inflation from hyperinflationary levels lowers inequality and poverty much more than further reductions to low, single digit levels.

In many poor countries where monetary instruments are few, reducing inflation requires restraining public spending. This is reflected in the macroeconomic policy prescriptions of many of the PRSP documents (Gottschalk). Such cutbacks affect, and

sometimes weigh heavily against, spending on social and poverty-reduction programs. They also affect spending to counter negative external demand shocks, which tend to affect the poor most. There is a balance to be struck between fiscal restraint to contain inflation and spending to protect the poor directly (Gottschalk). This balance is especially important, and perhaps hard to achieve, when economic growth is slowing down.

Land Reform

We noted earlier that land reform released growth in Vietnam and may do so in Malawi. The evidence in Lundberg and Squire (2003) is that land reform enhances growth on average in most countries and also improves the distribution of income substantially. This is because of the dual role of land as wealth and as a productive input. We saw that re-distributing land permits smallholder farmers to capture more economies of scale and adopt new technologies. It also provides a use for the under-employed labour of poor households and may improve their access to credit. Chirwa reports that a major reason income is distributed so unevenly in sub-Saharan Africa is that productive assets, especially land, are very unevenly distributed.

The experience of Vietnam, however, suggests that while land reform can initiate rapid growth, it cannot sustain it indefinitely. Le *et al.* conclude that agricultural growth in Vietnam is reaching its limits with the completion of reforms. It no longer provides a significant way out of poverty for the remaining poor. They specifically find that landlessness is not an important cause of household poverty.

Further, land reform in Vietnam did not preclude regional poverty traps nor did it prevent increasing inequality of income with growth (although it may have contained the increase in inequality). To enhance growth and address persistent poverty Le *et al.* call for a new wave of rural and national reforms to facilitate entrepreneurship and off-farm employment creation.

Agricultural Productivity Growth

In poor countries, as Ki emphasizes, incomes are distributed more uniformly in agricultural or rural areas than elsewhere. At the same time, Ki confirms the well-known feature of development that agriculture grows more slowly than do industry and

services, so that it's share of the economy declines over time. This does not mean, though, that new resources are less productive when invested in agriculture rather than elsewhere, especially in poor countries such as Tanzania where agricultural activities account for so much of the economy. Because of inter-sectoral linkages, a significant boost to agricultural productivity, such as occurred in Vietnam after its land reforms in the late 1980s, could generate the fastest overall growth as well as poverty reduction. Murphy *et al.* (1989) show that if the agricultural sector is important enough, a large increase in productivity will raise incomes sufficiently to generate strong domestic demand for manufactures and services. In this way, growth spreads through consumption linkages from the agricultural to other economic sectors.

A growth strategy that emphasizes increasing agricultural productivity, then, can be justified in terms of both poverty reduction and growth. It is immediately the most effective way to reduce aggregate poverty and will eventually stimulate demand for manufactures through the appearance of a rural middle-class. This is how some of the East Asian countries, including South Korea and Taiwan, achieved their growth-with-equity 'miracles'.

A purely agriculture-led growth strategy may not, however, be viable over the long term, as noted earlier for the case of Vietnam. Le *et al.* note that there is a steep negative correlation between poverty rates and the number of enterprises by province. They call for increasing off-farm employment, as agricultural and institutional reforms are exhausted.

Further, recent scholarship emphasizes that sustained growth depends largely on technological progress, and this growth process tends to concentrate in urban sites. That is, technological progress is characterized by local increasing returns to scale. Growth is faster when productive infrastructure, machinery and equipment and skilled labour locate close to each other in 'growth poles', rather than being spread out through rural areas (see Easterly, 2001, for a review of this literature). A strategy of agricultural growth may still work, especially in the event of a green revolution or if new export markets open up. However, if the agricultural sector is small, an urban-centred and industry-led growth strategy may yield faster overall growth. This reasoning may partly explain China's recent combination of fast growth and rapidly worsening income distribution, and its current strategy of large-scale urbanization, entailing a massive shift of the population from rural to urban areas.

4.2 Win-Lose Policies

The win-lose policies suggested by our research propositions cannot simply be discarded from a growth strategy because alternative win-win policies are available. Win-win does not always dominate win-lose. We already mentioned one reason for this – trade liberalisation, for example, is associated with a better growth rate than public education.

There is another reason why win-lose policies such as public investment in remote infrastructure are often critical. Sometimes they alone can address certain features of a country's poverty profile, including urban-rural or regional growth disparities which underlie an uneven distribution of income.

To deploy win-lose policies to advantage at the level of development strategy, it is necessary to understand the nature of the trade-off between outcomes.

Public Investment

In most poor countries poverty is particularly a rural or regional trait, as in Albania and Vietnam. This is in great part because infrastructure for production (such as irrigation facilities) and transport is not adequate in those areas. The inadequacy is not and usually cannot be corrected by private capital investors, for two reasons. First, the investment projects are naturally very large in scale, exceeding the resources of private investors or even the domestic financial sector. Second, the projects are not privately profitable at current levels of economic activity in the targeted regions, even if they are socially beneficial.

Public investment is needed to correct the imbalance of infrastructure between urban and rural or remote areas. But public capital for productive investment is also scarce. It is constrained by the limited scope for raising tax revenues in poor countries and inadequate foreign aid. It is also constrained by the need to avoid large fiscal deficits that have to be financed either by printing money (and so increasing the rate of price inflation) or borrowing too much. These requirements are another way in which poverty in poor countries influences the economy as a whole. Policy-makers must choose between investing in urban areas and in the manufacturing and services sectors where productivity and growth is high, or in remote regions where productivity and growth rates are lower but poverty tends to be higher.

Mancellari and Hida address this problem in Albania. They find that policy announcements favour public investment in infrastructure in the remote and mountainous regions. However, in practice, public spending goes disproportionately to the nearer middle-income regions, at the particular expense of the poorest and most remote regions. This is true for overall investment and for spending in particular sectors such as health and education. Mancellari and Hida reveal that the national government bases fiscal transfers to the provinces solely on their share of the population, without regard to differences in incomes or incidence of poverty. The allocation of public spending in this way partly explains the massive internal migration from remote to near regions and urban centres, and is magnified by that migration.

Considering the rising growth rates and inequality in China since the mid-1980s, Osmani (2000) wonders whether re-directing public investment to lagging regions could maintain rapid growth while reducing inequality. He does not think so.

> *The lagging areas seem to suffer from a spatial externality that makes for a lower rate of return to investment in comparison with the more advanced regions. If this is true, redirection of public investment toward these areas will involve a sacrifice of overall growth. Yet, faster pace of poverty reduction requires that public investment should be redirected toward these areas* (p.: 115).

The trade-off arising from the problem of where to invest public money is directly relevant to regional growth and poverty disparities. The trade-off is magnified by an indirect effect of the public investment choice, operating through the ability of the government to raise tax revenues. If public money is currently invested primarily in remote areas, future growth rates and the capacity to raise taxes for investment may fall. Alternatively, if taxes are raised now to ease the public investment trade-off, private investment will usually suffer, leading to lower overall growth rates in the future.

Trade Liberalisation

Trade liberalisation, as a component of economic 'openness' to the international economy, is one of the growth policies most likely to deliver fast growth and reduce the overall level of poverty. Unfortunately, in many cases it also tends to worsen the distribution of income. Lundberg and Squire (2003) find strong cross-country evidence

that trade and exchange rate openness affect growth and income distribution together and that there is a trade-off between the two. They find that the effect on growth is stronger than on distribution, so that openness tends to reduce poverty.

According to classical economic analysis, contrary to the empirical evidence, trade liberalisation should improve the distribution of income. That analysis presumes that poor countries have more unskilled labour than other factors of production, while rich countries have a preponderance of skilled labour (human capital) and physical capital. By the Ricardian principle of comparative advantage, poor countries will export unskilled-labour-intensive products, thus increasing the demand for, and wages of, unskilled labour. Since wages are the main income of the poor, they should benefit more from trade than the non-poor in poor countries.

There are at least two ways in which trade liberalisation, nevertheless, may aggravate income gaps in poor countries. First, many poor countries, especially in Latin America and sub-Saharan Africa, are relatively abundant in land and natural resources rather than in labour. According to Fischer (2001), after trade liberalisation exports of land-intensive products and natural resources increase, so that land- and natural resource-owners enjoy a capital gain; real wages may also rise. However, on the assumption that everyone earns the same wage but not everyone owns the same amount of land or natural resources, income inequality will also rise. Thus natural resource- and land-abundant countries face a trade liberalisation trade-off that labour-abundant countries, such as many in Asia, do not face.

Second, according to Aghion *et al.* (1999), trade liberalisation raises growth primarily through an increase in imports of material inputs. These inputs displace unskilled labour and introduce new technology which increases the demand for skilled labour, widening the unskilled-skilled wage gap. This occurs in all sectors that use imported inputs.

The effect of trade liberalisation on income distribution matters even if the growth effect dominates so that poverty is declining overall. This is because distribution contributes independently to development and welfare. We have cases and evidence where the populace rejected trade liberalisation as a growth policy because of its distributional consequences. Sachs (1987) contends, for example, that this is why a

strategy of export-led growth was politically much harder to adopt, and until the 1990s much less adopted, in Latin America than in Asia. Dutt and Mitra (2002) show with cross-country evidence that in countries with democratic majority-voting for governments the openness of trade policy depends on its consequences for inequality in the country.

In many cases it may be possible to compensate local losers from trade liberalisation by combining it with a targeted social safety net. This is the approach championed by Winters *et al.* (2002), and may be appropriate for Sri Lanka as described earlier by Jayanetti and Tilakaratna. In other cases, however, where the distributional consequences of liberalisation are severe and widespread, compensation may not be effective. One reason is that trade liberalisation also reduces the government's control over the economy. Spector (2001) points out that governments often re-distribute incomes by manipulating taxes which operate largely by changing equilibrium prices and wages. When trade in a small economy is liberalised, though, domestic prices and wages are set in the international market and taxes can no longer be used to offset widening income gaps.

The effect of trade liberalisation on income distribution also matters because it affects how much poverty falls in response to the growth that liberalisation produces. If the distribution of income worsens over time it reduces the poverty impact of growth, as in China (Yao *et al.*, 2004). This is more important when the initial distribution of income is already very unequal, as in Latin America and sub-Saharan Africa.

4.3 Uncertain Outcome Combinations

There will always be exceptions to the preceding allocation of policies among win-win and win-lose categories. The categories are only useful insofar as they emphasize and serve as a generally reliable guide to the multiple impacts of individual policies, as supported by experience with policy implementation. For some important policies, though, such as public education, the evidence is too equivocal to permit such a classification.

Mercado *et al.* argue that high quality public education, made accessible to the poor, can both reduce poverty and increase the growth rate of the economy by transforming

poverty from a static to a dynamic thing. They base their argument on a finding that static poverty or social immobility, which is pervasive in Bolivia, largely arises from low-quality public education, and that in Bolivia and many other countries social immobility is associated with low growth.

Lundberg and Squire (2003) show that a more educated population does indeed improve the distribution of income. However, they also discover that education does not promote growth, which is consistent with the balance of evidence elsewhere (Easterly, 2001). Public education has the potential to be a win-win policy, being necessary for attacking social immobility and effective in improving the distribution of income. But, according to Mercado *et al.*

> *High social mobility is not a sufficient condition for high growth. It also requires that productive activities yield higher returns to talent than unproductive rent-seeking activities. If talent is attracted to rent-seeking activities rather than productive activities, then growth will be limited irrespective of the degree of social mobility present in society* (p. 9).

Mercado *et al.* give two additional reasons why more education may not yield more growth. First, education may merely signal family background rather than indicate talent. Second, poor households may nevertheless not invest in education or devote effort to it if there is little demand for skills in the economy.

For public education to increase economic growth as well as improve the distribution of income by reducing social immobility, it may have to be accompanied by other growth policies. These include trade liberalisation to raise the demand for skilled labour and measures to restrain corruption and cronyism (that is, to limit rent-seeking opportunities).

5. Growth Strategy and Poverty Reduction

In poor countries, poverty occurs on a macroeconomic scale, so that it is deeply affected by both growth in incomes and the distribution of income. Moreover, growth and distribution interact complicatedly with compound effect on poverty, as indicated by our research from seven poor countries with variable geographies, institutions,

economic and political structures and past policy experiments. Policies conventionally thought of in terms of their ability to stimulate growth, such as macroeconomic stability, also directly influence distribution and poverty. Policies which re-distribute income or assets, such as land reform, also profoundly affect prospects for growth. Income poverty traps or social immobility constrain growth while regional poverty traps resist even rapid growth in the rest of the economy. Urban-rural growth disparities and key growth processes based on technological progress widen income gaps.

Growth and distribution and poverty reduction are inter-dependent in poor countries, but they are independent objectives of development strategy. These two principles guide and emerge from the preceding six research propositions. Together, the principles and propositions show how poverty in poor countries informs growth strategy. We understand the relationship at two levels, overall strategy design and individual policy selection.

With respect to poverty reduction strategy, first, the goal is not necessarily to maximize the rate of growth or to maximize the rate of poverty reduction. Rather, in the context of overall development strategy the goal is to achieve a balance between growth, distribution and poverty reduction. The appropriate balance cannot be identified by experts or by analysis, but can be achieved through an informed participatory social and political process as envisioned by local democratic institutions or the PRSP model.

Second, it is misleading to consider only conventional growth policies, or to investigate the effectiveness of growth policies only for growth and poverty outcomes. Re-distributive policies also affect growth and poverty outcomes.

Last, it is also ill-conceived to treat growth policy and re-distribution policy separately, since each modulates the effectiveness of the other. Growth and distribution policies cannot be combined in a poverty reduction strategy without considering their inter-active consequences.

We characterize the policies proposed by our eight background and country studies in terms of their joint impact on growth and distribution. Individual policies will generally have the potential to increase the rate of growth and improve the distribution

of income (win-win), or improve one and worsen the other (win-lose). This simple taxonomy yields the following prescriptions for policy selection for poverty reduction.

First, priority should be given to win-win policies, such as price and demand stability, land reform, agricultural productivity growth and, in appropriate circumstances, public education. These have the greatest reducing impact on poverty in poor countries. Currently PRSPs do emphasize price stability and public education, but do not explicitly link public education to the complementary institutional reforms needed to ensure that it actually promotes growth, such as anti-corruption and equal opportunities initiatives. They also do not emphasize land reform or contain credible plans to significantly boost agricultural productivity.

Second, some key win-lose growth policies, such as trade liberalisation, may be rejected not only in the event they are not expected to stimulate growth, but, even when they are expected to promote growth, because of their harmful impact on distribution. This is especially relevant where current income is very unevenly distributed, as in most of sub-Saharan Africa.

Third, not all such win-lose policies will, or indeed can, be rejected. That is, win-win policies do not always dominate win-lose policies, because there are multiple differences in the way each policy affects growth, distribution and poverty. Some win-lose policies may achieve a higher or more sustainable growth rate or a better distribution of income than alternative win-win policies. Some win-lose policies, such as public investment in remote areas, may more effectively address salient country-specific features of poverty or income distribution than the alternatives.

Fourth, individual growth policies may be modified from canonical form to incorporate or better accommodate re-distributive elements. Additionally, this may help to make policy reform politically feasible. For example, trade liberalisation rarely consists of a trade policy regime shift from autarky to free trade. The policy shift is typically not radical and may exclude or protecting sensitive sectors (see Rodrik, 2004, for a description of the heterodox liberalisations in Mauritius and China).

Finally, to avoid trade-offs in overall outcomes, and thus make win-lose policies more feasible and beneficial, countries may combine growth policies judiciously. That

is, a strategy is not a single policy, but a combination or sequence of policies. For example, a poverty reduction strategy may package together land reform, education subsidies and trade liberalisation policies. Strategists should be aware too that policies operate differently alone than together with other policies, because the policies interact with each other.

These considerations indicate that growth strategy should respond to the features of poverty, growth and distribution processes in individual poor countries. In this they would reflect the range of analyses and variety of growth and distribution policies for poverty reduction proposed in our country research papers. Poverty-informed growth strategy depends on context, and is likely to differ from country to country. Its legitimacy depends not only on conformity to conventional international formulations, but also on how it reflects local features of poverty and growth and income distribution processes.

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Appendix: Project research papers

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