Center for Global Development

CGD Brief

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Connecting the Poor to Economic Growth: Eight Key Questions

By Sarah Lucas and Peter Timmer *

Summary: It has long been understood that economic growth is the essential foundation for poverty reduction. The key to income growth is the expansion of jobs that pay sustainable remunerative wages, and the two keys areas of production in this vein have almost always been agriculture and labor-intensive manufactured exports. Rising average incomes, both personal and national, are a necessary ingredient for improved livelihoods, but they do not guarantee broad-based poverty reduction. Economic history shows that countries, and communities within countries, with similar growth rates can have very different degrees of success in connecting growth to the poor and translating it into sustained poverty reduction.

This variation leads to several questions: What allows growth to reduce poverty more in some countries than others? How can the poor best connect to, participate in, and benefit from economic growth? And how can countries, both developing and donor nations, plan for and support economic growth that reaches the poor? The questions are particularly relevant for the new U.S. aid initiative committed to "reducing poverty through economic growth"—the Millennium Challenge Account (MCA).

There is no one policy formula that will guarantee the highest rates of poverty reduction in any given country or region. This brief presents a framework for connecting growth to poverty reduction and asks eight key questions that country officials and MCA staff can use to guide their evaluations of the poverty-reducing potential of country proposals for MCA assistance.

Poverty Reduction Through Economic Growth: Eight Key Questions

1. What is the macroeconomic environment in the country?
2. What are the initial conditions in the country?
3. What is the state of agricultural development in the country?
4. Are the mechanisms in place to link the poor to economic growth?
5. What is the nature of labor markets in the country?
6. Do the poor have the skills and assets necessary to participate in and benefit from economic growth?
7. To what degree do women have equal access to mechanisms and assets necessary to connect to and benefit from economic growth?
8. Does the country have the political will to connect the poor to economic growth?

*This brief draws heavily on the work of the Operationalizing Pro-Poor Growth program, a collaboration of the World Bank, the UK Department for International Development (DFID), French Development Agency (AFD), and Bundesministerium fur wirtschaftliche Zusammenarbeit und Entwicklung (BMZ), to which Peter Timmer is a contributor. More information is available at *www.worldbank.org/propoorgrowth*. Sarah Lucas is Senior Associate for Outreach and Policy, and Peter Timmer is a Senior Fellow at the Center for Global Development.

Introduction

It has long been understood that economic growth is the essential foundation for poverty reduction. Rising average incomes, both personal and national, are a necessary ingredient for improved livelihoods. As Figure 1 shows, the relationship between economic growth and poverty reduction is strongly positive overall. But countries, and communities within countries, experience growth in very different ways. For example, Bangladesh experienced an average annual growth rate more than twice that of Ghana but the poor in Ghana saw their incomes rise substantially more than the incomes of the poor in Bangladesh (see Figure 1). While Senegal and Burkina Faso experienced the same average rate of annual growth between 1995 and 2002, the different rates of poverty reduction were such that it would take Senegal 28 years to halve poverty, while it would take Burkina Faso 40 years to achieve the same goal.

The variance shown in Figure 1 is repeated in countries around the world, and leads to several key questions: What allows growth to reduce poverty more effectively in some countries than others? How can the poor best connect to and benefit from economic growth? And how can countries, both developing and donor nations, plan for and support economic growth that reaches the poor?

While these questions have long concerned development practitioners, they are now at the forefront of the development policy agenda of the U.S. The MCA has the mission of " reducing poverty through economic growth." MCA-eligible countries are invited to develop funding proposals through national deliberation and submit them to the Millennium Challenge Corporation (MCC). These proposals then serve as a basis for negotiation with the MCC over a final country " compact" or set of funding priorities. The design and negotiation of the compacts provide valuable opportunities to assess their potential to reduce poverty through economic growth.

This brief presents a framework for linking growth to poverty reduction and asks eight key questions that country officials and

Figure 1: Growth and Poverty Reduction: Not a Simple Relationship

Source: World Bank, Operationalizing Pro-Poor Growth research program.

MCC staff can use to guide their evaluations of the poverty-reducing potential of country compact proposals.

The Framework for Linking Growth to Poverty Reduction

Three elements should serve as a foundation for any national strategy attempting to maximize poverty reduction through economic growth (See Figure 2):

1) A macroeconomic policy framework that fosters stability, is oriented toward growth, and is supported by an understanding of the nature of past growth.
2) Mechanisms to help reduce the costs for the poor of accessing the sectors where growth is occurring, and to foster growth in the sectors where the poor are located.
3) Public investment in the capacity of the poor to participate in and benefit from economic growth.

Eight Key Questions

1. What is the macroeconomic environment in the country? Macroeconomic stability is the foundation of both overall growth and equitable growth. Without it, policies targeted at poverty reduction are unlikely to be successful.

The MCA has an inbuilt structure for assessing several aspects of macroeconomic stability in a country. Of the 16 indicators used to select MCA-eligible countries, six, such as inflation, budget deficit, and trade policy, are in the category of "economic freedom."

High rates of inflation hit hard on businesspeople, small or large, by making new investments riskier, and business less profitable. The poor are the least able to buffer themselves against inflation; increasing rates of inflation are associated not only with increasing poverty, but also with increases in infant mortality.

The budget deficit is a key indicator of overall macroeconomic policy, with larger deficits generally associated with macroeconomic instability, inflation, and exchange rate depreciation. Countries that have budget deficits above the mean for the pool of MCA candidate countries–3.5 percent for the FY 2005 selection process—are less likely to qualify for MCA funds.

Many development experts would agree that, broadly speaking, trade openness is good for growth and poverty reduction. There is ongoing controversy, however, on what kind of trade policy is best for developing countries and how it should be measured. The MCC currently uses the trade component of the Heritage Foundation/*Wall Street Journal* Index of Economic Freedom, which subjectively rates countries based on judgments about tariff and quota rates. Though not explicitly measured by the MCA, another indicator of macroeconomic health is the real exchange rate which has a direct impact on the competitiveness of exports.

Though countries do not have to pass all six economic indicators, the MCC has made it clear that it will not consider countries that fall substantially below the cutoff on any single indicator.

2. What are initial conditions in the country? Strategies for fostering poverty reduction through economic growth are different at different stages of development. While the MCA is focused only on low-income countries (lower-middle income countries will be eligible in 2006), there is quite a wide range among the countries. Madagascar, with an annual per capita income of $230, is the first country to sign a compact with the MCC, while other eligible countries include Honduras and Cape Verde with per capita annual incomes of $930 and $1250, respectively.

Beyond per capita income, several key aspects of a country are fundamental to understanding how best to foster poverty reduction through economic growth:

What is the level of, and change in, income inequality? In most cases, initial levels of inequality and changes in inequality are the two factors that cause rates of poverty reduction to differ across similar growth experiences, with higher rates of initial inequality leading to fewer gains from growth for the poor. In fact, in countries with very high rates of inequality, overall growth may be ineffective in reducing poverty.

Growth in the 1990s (unlike that of the 1970s and 1980s) in most countries has led to rising income inequality. This is due mainly to the fact that the poor were concentrated in rural areas and the agricultural sector, and were largely cut off from the non-agricultural sector that drove the growth. For example, two countries that experienced among the largest increases in inequality in this period–Uganda and Vietnam—were those that saw the largest differences between growth in agriculture and that in the rest of the economy. In Uganda, overall per capita growth was 5 percent per year but only 1.6 percent in agriculture. In Vietnam, overall per capita growth was an impressive 7 percent annually, but only 2.6 percent in agriculture.

The fact that inequality is rising does not necessarily mean that poverty reduction is not occurring. It may be necessary to tolerate some increase in inequality as markets begin to work better, and this can be acceptable if the number of poor is falling substantially (as it did in Vietnam). Increased *perceptions* of inequality, however, can create political opposition to economic reforms and therefore should not be ignored. No matter what, policy makers need to monitor inequality as well as growth.

Table 1: The Role of Agriculture in MCA-Eligible Countries

	Agriculture as a share of:		**Average annual growth of:**	
Country	National economy	National labor force	Overall GDP	Agriculture GDP
Armenia	26.2	12.0	0.4	1.4
Benin	36.0	52.0	4.9	5.7
Bolivia	14.5	44.0	3.6	2.7
Cape Verde	11.0	22.0	6.0	5.4
Georgia	20.6	19.0	-4.3	na
Ghana	33.8	56.0	4.3	3.5
Honduras	13.5	30.0	3.1	2.1
Lesotho	16.4	39.0	3.5	2.0
Madagascar	32.0	73.0	2.1	1.9
Mali	32.4	80.0	4.2	2.5
Mongolia	29.7	23.0	1.5	3.2
Morocco	16.1	35.0	2.6	0.1
Mozambique	23.5	81.0	6.9	5.1
Nicaragua	18.0	19.0	4.3	3.1
Senegal	15.0	73.0	3.9	1.8
Sri Lanka	20.1	45.0	4.8	1.6
Vanuatu	17.4	na	2.9	2.4

Sources: Food and Agriculture Indicators, FAO 2004. Accessed March 2005. *http://www.fao.org/es/ess/compendium_2004/list.asp*

Where are the poor? An important first step in understanding how to best reach the poor in a given country is to know where poor people are concentrated, both regionally and sectorally. On average across the developing world, rural poverty makes up 70 percent of total poverty, though it is as high as 90 percent in countries such as Uganda, Burkina Faso and Vietnam. By contrast, just under 30 percent of Brazil's poor are in rural areas, while about 50 percent of the poor in Bolivia are in rural areas.

What is the role of agriculture in the national economy? Two key questions help evaluate the potential of agricultural development as an engine of growth and poverty reduction: What is agriculture's share of the national economy? And what share of the national labor force is employed in agriculture? In the case of Mali, agriculture makes up 32.4 percent of the national economy but 80 percent of the labor force, so labor productivity in agriculture is very low and growth in the sector lagged behind overall growth. Labor productivity is much higher in Mongolia where agriculture makes up 29.7 percent of the economy but only 23 percent of the labor force—one reason why growth in this sector has outpaced overall growth. Table 1 illustrates the great diversity among MCA countries in the role that agriculture plays in a nation's economy, the productivity of the labor force in agriculture, and the relationship between overall growth and growth in the agricultural sector.

3. What is the state of agricultural development in the country? Agriculture has traditionally made up a large share of economic activity in poor countries and has long been understood to play a key role in their economic growth. When agricultural growth has involved broad-based increases in productivity among small, family-owned farms, it has increased food security directly and indirectly through a reduction in food prices for the country's consumers. Several factors are important to understanding this potential:

Where is agricultural growth concentrated? In countries such as Brazil, Bolivia and Zambia that have very unequal land distribution and a bi-modal agricultural sector–a dynamic large-scale commercial sector contrasted with a stagnant and often geographically isolated small-scale rural sector—agricultural growth has been concentrated in the commercial, export-oriented sectors, and has not translated to broad-based poverty reduction. In contrast, in Uganda and Vietnam, where small farmers have actively participated in the production of key export crops (coffee and rice respectively), growth in these areas has reduced poverty.

Do the rural poor have access to the assets necessary to increase productivity and access markets? Land is the most obvious asset for agricultural development, making reliable property rights essential. But access to education and capital, and infrastructure such as rural feeder roads, electricity, and irrigation, are increasingly important to make land assets productive. These broader assets allow the rural poor to connect to markets for their goods and for the inputs to their own production. Following the Green Revolution in Asia, for example, agricultural productivity increased by 4 percent for every additional year of formal schooling.

What is the nature of land tenure and distribution? The equality of land distribution varies dramatically across countries. In countries with relatively high levels of inequality in land holdings, agricultural growth does less than non-agricultural growth to raise the incomes of the very poorest. In some cases, the inequality of land distribution actually hinders the growth of agricultural outputs. This inequality can be addressed through land reform where politically feasible. Even in the absence of overall land reform, improvements in property rights and land markets can give land holders the incentives and resources necessary to make long-term investments in productivity increases.

4. Are the mechanisms in place to link the poor to economic growth? Essential to bridging economic growth and poverty reduction are mechanisms that facilitate access to sectors where growth is occurring, and that foster growth in the sectors where the poor are located. The fundamental issue here is whether the poor can connect their capabilities and their products to markets and other sources of economic growth, or if the transaction costs (including risks) are too high for them to do so. The following factors need consideration:

Infrastructure. Infrastructure investments have played a conspicuous role in linking the poor to economic growth in several countries. For example, economic growth in Indonesia had a particularly strong impact on poverty reduction between the late 1970s and the 1990s, with the incomes of the poor rising by 6 percent per year (compared to the dismal 2.5 percent annual *decrease* in the incomes of the poor in the earlier half of the century). It is no coincidence that in this period road coverage expanded by 8.3 percent per year. Farm-to-market roads in particular increased from 8,500 kilometers in 1977 to 31,900 kilometers in 1998. In Uganda, households with initial access to electricity experienced income growth that was 6 percentage points higher than households without electricity. But public expenditure in major infrastructure projects can be controversial, and the link to poverty reduction is by no means guaranteed. Inequalities in access to electricity, telecommunications, irrigation, roads and ports can easily emerge if measures are not taken to explicitly link them to the poor.

Access to credit. Access to low-risk and low-cost financing is out of reach for many of the world's poor, making it nearly impossible for them to invest in improvements in their current area of work, or to diversify into other types of income-generating activities. India has taken an ambitious approach in addressing the limited access to financing in rural areas. From the 1970s to the 1990s, banks that opened a branch in urban areas were also required to offer services in "unbanked" areas. The special focus on serving priority sectors such as small entrepreneurs, agriculturalists, and poor households promoted entrepreneurship, supported infrastructure development, and accelerated poverty reduction.

5. What is the nature of labor markets in the country? Relative to staying in agriculture, moving into employment in the non-farm sector (even if informal) significantly increases the chances of moving out of poverty. Moving into the formal sector yields the largest income gains. Labor is the primary asset of the poor, and the degree to which the poor are successfully mobile within the labor market depends both on the human assets they bring to the market, and on the structure and flexibility of the labor market itself. In most developing countries the poor are employed—the challenge lies in raising their productivity. Three questions are key to understanding how this challenge can be met:

What is the labor-intensity of growth? In general, the more labor-intensive growth is, the more likely it is to have a positive impact on the livelihoods of the poor. For example, Indonesia's economic growth from the 1960s to the 1990s was derived mainly from three major sources: economic recovery and rehabilitation of the badly run-down capital stock and infrastructure; rapid growth in agricultural productivity through use of new technologies and massive investment in rural infrastructure; and, over time, the emergence of a dominant manufacturing sector. All of these relied on the abundance of unskilled labor in the country, which was the secret to the poverty-alleviating power of Indonesia's growth in this period.

What is the skill-composition of the sectors that contribute to growth? The skill-composition of labor demand has important implications for the income earned by the poor. In Tunisia, for example, the sectoral composition of employment has changed dramatically over the past four decades. From the 1960s to the late 1990s, the share of employment in agriculture fell by half, from 46 percent to 23 percent. This reflects a move into manufacturing, which has seen its share rise from 14 percent to 24 percent in the same period. The growth of the manufacturing sector, almost half of which is attributed to the production of textiles, clothing and leather, has been particularly important for poverty reduction because 75 percent of its employees are low-skilled female workers from low-income households.

What is the nature of regulation in the labor market? One controversial element of structural adjustment in the developing world has been labor market reform, which often focused on altering minimum wage and unemployment benefits. The challenge to policy makers is in striking an appropriate balance between labor market flexibility and protection for workers.

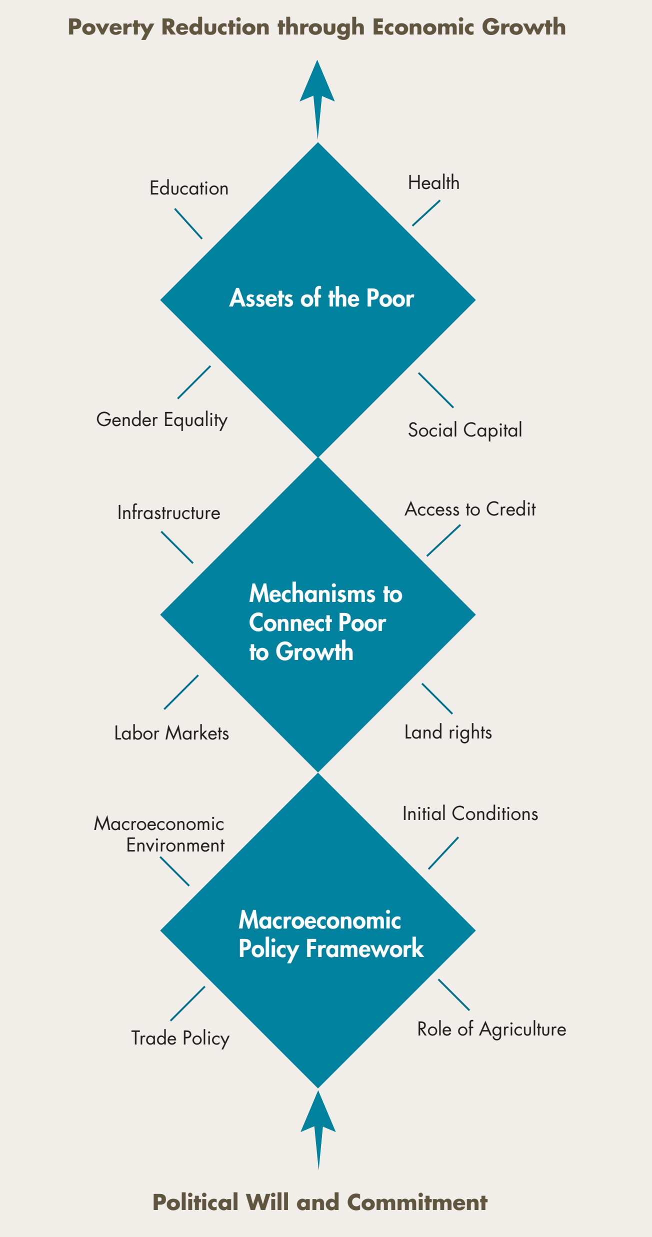
In Bolivia, for instance, rural workers and the urban poor are concentrated in the informal and self-employed sectors. This is due, in part, to the tight regulation of the formal labor market, which restricts these groups' movement into higher-wage employment. Though Tunisia's labor code underwent changes in the 1990s to allow for more flexibility in hiring and setting limits on severance compensations, it still provides higher protection for workers than in several other developing countries, and has established an official system of collective bargaining by which wages are negotiated once every three years. Thus the growth in the manufacturing and garment industries cannot be attributed to a lack of protection of worker rights. On the other hand, Tunisia's unemployment rate has remained relatively high over the past 20 years—15 percent in the active labor force—and some argue that the current levels of protection in labor markets contribute to this problem.

6. Do the poor have the skills and assets necessary to participate in and benefit from economic growth? Until now we have focused broadly on the structure of the economy and the physical assets that facilitate growth and poverty reduction. But in the end, it is personal and household livelihoods that matter, and the potential to improve them is sharply defined by less tangible assets that allow the poor to participate in and benefit from economic growth—their levels of education and health.

Education. Education plays a key role, if not the most important role, in allowing farmers to increase their productivity, and workers to transition from agriculture to other rural economic activities, or from the informal to formal sector. In many poor countries, people with just one additional year of schooling earn 10 percent higher wages. No country has ever achieved continuous and rapid growth without reaching an adult literacy rate of at least 40 percent. With education, people are also far better able to prevent disease and to use health services effectively. For example, young people between the ages of 15 to 24 years who have completed primary education are less than half as likely to contract HIV as those who have little or no schooling.

The majority of farmers in the developing world are women. Greater female education leads to more productive farming and has particularly high returns in other areas as well, leading to lower fertility rates, lower infant mortality levels, and higher education rates for the next generation. Female literacy also accounts for over 40 percent of the global decline in malnutrition between 1970 and 1995.

Figure 2: A Framework for Poverty Reduction through Economic Growth



Health. Investments in health have significant impacts on economic growth and poverty reduction in both direct and indirect ways. Directly, healthy workers are more productive over the course of longer lives. The massive global effort to eradicate River Blindness in sub-Saharan Africa not only halted transmission in 11 countries, prevented 600,000 cases of blindness, allowed 18 million children to live free from fear of the disease, but also had important spillover effects by liberating 25 million hectares of arable land—enough to employ millions of agricultural producers and to feed an additional 17 million people.

Far too many people still lose family members, livelihoods and futures to malaria, diarrheal disease, HIV/AIDS, respiratory infections, and countless other preventable diseases, with devastating effects on growth and poverty reduction. Improving basic maternal health and lowering fertility rates are fundamental—apart from the direct and positive implications for per capita GDP, reduction of fertility rates translates into higher household investments in the education and health of children.

7. To what degree do women have equal access to mechanisms and assets necessary to connect to and benefit from economic growth? There are countless ways in which unequal opportunities for women hinder economic growth. Gender inequality in both education and employment not only limit earning potential for individual women, but also slow economic growth by limiting the pool of people contributing to it. In addition, rising female education and earnings levels are often associated with falling fertility levels, lower infant mortality rates, and increased investment in the education of future generations, all of which have positive impacts on economic growth.

Gender inequalities can also hinder the potential for growth to reduce poverty. For example, while women tend to make up a large proportion of small, rural agricultural producers (especially in Africa), female farmers tend to have little or no formal control over land, only limited access to productivity-enhancing inputs like fertilizer, and a small role in the production of cash crops. When growth does occur in the agricultural sector, it is far less likely to benefit women than men, and so has a diluted effect on poverty reduction.

Gender inequality in India is among the highest in the world, but varies substantially across states within the country. In states where female literacy and female labor participation were highest in the 1960s, growth over the subsequent three decades was not only higher, but also particularly effective at reducing poverty. Gender inequality makes it especially difficult for women to participate in and benefit from the growth process, particularly in higher-skill areas of employment.

8. Does the country have the political will to connect the poor to economic growth? Political leadership is often the critical factor in connecting the poor to economic growth. Effective leadership is demonstrated by how a country answers the questions listed here, but it is also important in more fundamental ways. For example, Indonesia's period of impressive growth from the 1960s to 1990s was the result of a deliberate strategy that combined rapid economic growth with investments and policies that insured that the growth would reach the poor. Bangladesh has had a long-term political commitment, transcending regime changes, to social development, reflected in investments in primary education and health care, the provision of access to clean water, and efforts to slow population growth.

In the early sixties Tunisia made a serious commitment to women by: 1) banning polygamy and promoting women's emancipation; 2) promoting birth control and family planning; and 3) making schooling compulsory for girls and boys alike.

The banning of polygamy ushered in a rapid transformation of society, and the commitment to women's empowerment served as the cornerstone of policies to promote family planning and female education. The schooling of girls has led to a greater participation of women in the labor market and facilitated the rapid development of labor-intensive industries such as textiles and garments. As a result, Tunisia has the lowest population growth in the Middle East and North Africa, a factor that has likely played a major role in poverty alleviation.

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