Making Growth Work Better for the Poor: MMW4P's Role in Growth Strategies

The Making Markets Work Better for the Poor (MMW4P) framework has an important role to play in countries seeking shared growth. The key messages regarding the role MMW4P may play in developing strategies that will help to accelerate shared growth are:

Context

1) **Growth receives insufficient attention in Poverty Reduction Strategies (PRS's). They need to be underpinned by robust strategies to promote shared growth.** Though 2nd generation PRS's have increased their focus on growth, they continue to assume future growth rates that are far higher than those achieved historically by the country. They, and national development plans (NDPs), fail to set out why or how growth will accelerate. It is not surprising, therefore, that countries frequently fail to achieve growth targets and these strategies, even if based on broad based consultation, fail. Moreover, the effect growth has on reducing poverty varies substantially. NDPs and PRS's pay little attention to whether the pattern of growth is enabling the poor to participate in and benefit from the growth process. NDP's and PRS's need to be supported by robust growth strategies that will help to accelerate growth and the rate at which the incomes of the poor are rising, delivering shared growth.

2) **Markets play a crucial role in accelerating shared growth. The functioning and fairness of markets receives limited attention in growth strategies.** Markets are the central organizing principle of economic activity and determine what gets produced where and who gets what out of economic activities. Markets for finance, land and labour and those from which the majority of the work force earns its livelihood have been shown to be causal factors in increasing growth and the incomes of the poor. Currently, growth strategies pay limited attention to markets.

Key Messages

3) **Growth strategies need to be informed by the growth, inequality, poverty experience of the country.** In this regard economic and social analysis, including studies of how the incomes of the poor are fairing, should help to establish:

- Is growth broad based and robust and what are the key external and internal risks that may derail it?
- Whether the rate of growth achieved in the past would have been sufficient to achieve the desired rate of poverty reduction (MDG or national goal) and the effect that distributional changes have had on the incomes of the poor. Is growth or distribution the major issue?
- Is growth taking place in the regions, sectors and markets that matter for the incomes of the poor and are the pace and pattern of growth providing sufficient opportunity for the poor to escape poverty?
- What are the main factors that have enabled households to escape poverty in the past ownership of land or property, access to social services and infrastructure, occupation of head of household, access to particular markets etc. - and how have social structures and norms (membership of ethnic groups, gender etc.) affected income poverty?
- What are the main livelihood strategies adopted by the various types of poor household and what are the possible pathways out of poverty for each? The poor may escape poverty in two ways: improving their incomes from existing livelihood strategies (stepping-up) or adopting new livelihood strategies that offer better incomes (stepping out)[ii]. Which is the most relevant for each type of poor household?
- What is the level of informality in the country and is it increasing? Is there evidence that the poor, unable to find formal employment, are increasingly stuck in low productivity/low income occupations that prevent them contributing strongly to growth and escape poverty? How is the labour market performing and is it providing sufficient opportunity to provide employment for the work force in well paid, formal jobs? How strong are the incentives and barriers to formality?

4) **The conditions for bringing about a**

pace and pattern of growth that reduces poverty rapidly depends crucially on markets functioning well and fairly. Five conditions contribute to a pace and pattern of growth that will reduce poverty rapidly:

i) **Broad based entrepreneurship and investment.** Broad based entrepreneurship and investment helps to: i) make growth more robust, less vulnerable to outcomes in a limited number of sectors and markets; and ii) provides greater opportunities for the poor to participate and benefit from growth as producers and employees. Broadening entrepreneurship and investment requires investment climate reforms, including greater access to infrastructure, and improving the functioning of key markets. Markets for the factors of production (land, labour, finance) are particularly important for broadening entrepreneurship and investment to deliver shared growth;

ii) **Higher productivity through greater competition and innovation.** In addition to greater investment, the other major source of growth is greater productivity of the factors of production[iii]. Countries that have recorded high rates of investment, without accompanying increases in productivity (e.g. the former Soviet Union), have not been able to sustain growth as low returns undermined investment. Rising productivity also provides greater opportunity for the work force to increase their incomes delivering shared growth. Rising productivity in agriculture and labour intensive manufacturing have been shown to be the major source of productivity growth in the developing countries. Addressing the functioning of markets in which the bulk of the work force participates can help to raise productivity and contribute to competitiveness by increasing the efficiency of production and exchange. Competitiveness helps to underpin growth by increasing the returns to investment and provides opportunities to serve wider international markets.

iii) **Harnessing the benefits of greater international trade and investment.** Greater international trade and investment have been shown to be important factors in accelerating growth. For the poor to benefit from international trade and investment, export markets for products and services they produce need to work better and more fairly. In addition, labour markets need to work effectively, resulting in an increase in demand for labour and equipping the poor to supply the type of labour needed. Where trade and investment cause structural changes which cause the incomes of the poor to fall, assistance may be required for the poor to adopt alternative livelihood strategies.

iv) **Improved market access and functioning.** Addressing government and market failures and deepening markets so that they are better able to grow and meet demand efficiently, helps to increase growth. Ensuring that the poor have access to and a level playing field in markets they need to improve their livelihoods and meet their consumption needs helps the poor to contribute to and benefit from growth; and

v) **Addressing risk and vulnerability.** Because the poor are especially vulnerable, they may not take the risks involved in adopting better livelihood strategies. Natural and man-made shocks may cause the poor to fall into poverty traps from which they cannot escape. It is important therefore to prevent, mitigate and help the poor cope with shocks and provide social protection that will help them to adopt better livelihood strategies and avoid falling into poverty traps. Markets for insurance, drought resistant crops, animal health, irrigation and better functioning labour markets, with reduced search costs, are important for reducing risk and vulnerability.

5) **MMW4P has a successful track record in addressing access to finance and financial deepening.** FinMark has proven that backing the ambitions of legitimate and credible stakeholders that are committed to improving market outcomes for the poor can have large pay backs in the financial sector. By providing credible research on the extent to which the needs of the poor are being met, engaging with policy makers to develop a more inclusive financial sector, improving market infrastructure and catalysing innovation in the private sector, it has helped to play a facilitating role in improving access to finance for millions of the previously unbanked and promoted financial deepening in South Africa.

6) **The Employment Promotion Programme (EPP) has shown that it is possible to make progress on improving the functioning of labour markets even when reform is politically contested.** The programme brought together the three main stakeholders - Government (The Presidency), employers and trade unions - and empowered them

to lead a process that involved: i) commissioning respected academics to provide the evidence for labour market reforms with the result that they came to realise the considerable common ground between them; ii) providing expertise to reduce barriers to investment and undertake labour market reforms; iii) improving the functioning of labour market institutions; iv) strengthening the vocational training system to make it more relevant to the needs of employers; v) promoting labour intensive methods of construction to increase the employment effect of public investment. The programme epitomises the **M**acro environment, **I**nvestment and infrastructure, **L**abour market regulations and institutions, **E**ducation and skills and **S**ocial protection (MILES) approach that the World Bank is attempting to develop to improve labour market functioning[iv]. The Economic Adviser to the President called it one of the most effective programmes of donor assistance in his 30 years in development.

7) MMW4P programmes have had large, sustained impacts on the livelihoods of the poor. There are other markets to which MMW4P is well suited. ComMark has supported stakeholders in Lesotho's garment industry meet the challenge of losing preferential access to world markets and thus safeguard the future of the country's largest source of formal employment and exports. Instead of the collapse of the industry predicted by the 'experts', the industry has increased employment and exports. In Bangladesh, Katalyst[v] has supported suppliers of farm inputs and fingerlings to provide information and advice to over 60,000 farmers increasing productivity by 10%-12%. DFID has established programmes that address other markets such as land (LandMark in South Africa) and is exploring the use of MMW4P in making infrastructure markets work better for the poor. The MMW4P framework is suited to a wide range of markets to which it is yet to be applied.

8) Attempting rapid and broad based reforms simultaneously is likely to fail. What is required is to identify and address the binding constraints to growth. Rapid, broad based reforms are likely to meet with strong resistance as each is likely to produce some losers. Even if resistance to change is overcome, the result may be huge economic disruption and social dislocation as occurred in the economies in transition. There are also arguments against attempting broad reforms based on economic theory[vi]. Successful reform is incremental, as China and India have proved. It is important therefore to identify the binding constraints to growth. The analysis of the growth, poverty, inequality experience described above, combined with analysing the extent to which the five conditions for bringing about a pace and pattern of growth that will reduce poverty rapidly are in place, should help to set the agenda for identifying the binding constraint.

9) The binding constraint will be associated with a set of markets. The MMW4P framework may be applied to make those markets function better and with greater fairness for the poor. The binding constraint may be identified by analysing which of three situations holds in the country[vii]: i) returns are low across the economy (social returns); ii) entrepreneurs cannot capture the returns to investment (low appropriability); iii) the cost of capital is too high. Each condition will be associated with causal factors, including the functioning of markets as follows:

a) If social returns are low, human capital (health and education) may be underdeveloped undermining productivity of the work force or infrastructure inadequate, causing high cost of investment, low productivity (power, water) or high cost of exchange (transport). Poor human capital or infrastructure may form the subject of MMW4P interventions with aid provided to improve public and private investment within a robust regulatory framework that ensures strong operational performance, including the maintenance of assets;

b) If social returns are acceptable but entrepreneurs are unable to earn an appropriate risk adjusted rate of return (appropriability), the cause may be government or market failure. If it is government failure, it may be caused by macro risks of instability (fiscal, monetary, financial) or micro risks of corruption, low property rights, high taxes or other constraints in the business environment. If market failure: the cost of acquiring information to facilitate exchange, meet the needs of buyers and whether it would be possible to make new products cost competitively (cost discovery) may be too high; market power may be used to capture rents or; there may be problems of co-ordination whereby lack of investment in one activity holds back investment in others. Government failure at a macro level may be addressed by support for the public sector in improving macro-economic stability and improving the investment climate, with the private sector and civil society holding the public sector to account.

If the constraint is government failure at a market level or market failure, then MMW4P interventions will be appropriate;

c) If it is the high cost of finance that is the binding constraint, it may be caused by poor access to international finance or problems in domestic capital markets. The former may be addressed by programmes to improve the country's debt rating. The latter may call for a combination of better macro management[viii] to reduce crowding out of the private sector by the public and MMW4P interventions to make the financial market work better for the poor.

10) The appropriate response to government failure will depend on the capacity of government and the extent to which the state is responsive to the interests of the poor. The capability and willingness of governments to address government failures, in the form of inappropriate policies and institutions and a lack of investment in public goods, will vary from country to country. Responses to address government failures will therefore need to be suited to the context. In MICs with capable governments that are responsive to the interests of the poor, initiatives may rest inside or be close to government, assisting those who represent the interests of the poor to engage in the development and implementation of policy and institutional reforms. In poorer countries, where governments are less capable of implementing reforms effectively or in countries where governments are less responsive to the interests of the poor, initiatives may well be positioned further from government, working predominantly with the private sector & influencing policy from the outside by supporting constituencies in favour of pro-poor reforms to overcome opposition from vested interest.

11) The response to market failure will depend on the attitudes and capabilities of the public and private sectors. Market failures such as adverse market power, uneven access to information, inadequate supply of public goods and co-ordination failures may be addressed by government intervention. However, if legal and administrative systems do not work it makes little sense to attempt to address market failures through the public sector. In that eventuality, it would make more sense to address market failure through the private sector. However, the capability and motivation of the private sector to address market failure varies tremendously. Even some MICs have weak private sectors that are not responsive to the public interest. Where the capability of the private sector is weak, or it is not willing to work in the public interest, there may be a need to build capacity and align business objectives closer to development objectives before attempting market reforms.

12) Before deciding on whether to support specific initiatives, a judgement call will need to be made as to the scope and feasibility of change. Even if a market has been identified as a binding constraint to shared growth, it is not necessary that it will be suitable for an MMW4P programme. For an MMW4P programme to be attempted, a judgement call needs to be made to establish the scope and feasibility of achieving systemic change, involving whether:

a) There is scope for large impacts through systemic change. It should be possible to identify specific government or market failures that are undermining market functioning or fairness which, if addressed, would have a major effect on growth and the incomes of the poor;

b) It is feasible to bring about systemic change in the short to medium term (3-5 years) as: i) resistance to policy and institutional change is not entrenched or will not involve strong vested interest; ii) infrastructure needed to support the functioning of markets, including the supply of public goods, can be improved by the public or private sectors; iii) market drivers provide strong incentive to overcome market failures and innovate to improve the poor's access to and returns from the market, and iv) there are capable private actors that can be motivated to align business objectives closer to development objectives.

c) The extent to which conditions approximate the 'perfect storm' of pro-poor policy or market issues that demand a response from market participants, legitimate and credible stakeholders that are willing to respond, and strong capable actors in the private sector that are able to deliver systemic change with or without policy or institutional change .

Implications for donors

i) **Donors should support country led growth strategies that set out how growth will be accelerated and benefit the poor.** DFID country offices need to work with the state, the private sector and civil society in the host country, and development partners, in ensuring that robust strategies to promote shared growth are in place. Such strategies need to be informed by the growth, poverty, inequality experience of the country, whether the conditions for shared growth are in place and the binding constraints to shared growth. They should base their scaling up of assistance in support of growth, informed by such growth strategies.

ii) **Understanding the functioning and fairness of markets should form an important element of country led growth strategies.** Market outcomes affect both the pace and pattern of growth and the extent to which the poor are able to participate in and benefit from the growth process. Identifying markets that form part of the binding constraint to shared growth and assessing their functioning and fairness will help to develop effective strategies for promoting shared growth.

iii) **Greater understanding and focus is required on the extent of market and government failures and how these can be addressed.** As government and market failures are pervasive in the developing countries, and the poor are disadvantaged by such failures, it is important for donors to help governments identify the extent and causes of failures in markets that form part of the binding constraint to shared growth.

iv) **Greater realism is required on the capacity of governments and the extent to which they are capable to regulate and provide the necessary public functions and oversight of markets.** Donors must be realistic on the capacity of government and the extent to which they are willing to govern markets effectively. Are Governments able to provide the necessary public functions of appropriate policies and institutions and the provision of public goods? Are they able and willing to assess market externalities and provide the necessary policies to improve market functioning? Are they able to overcome vested interest and ensure sufficient competition and assist with information flows around markets? Where this is not the case, providing technical solutions will not be the answer. Greater effort is therefore required to find different models and options for addressing government and market failure, developing regional capacities where national is not feasible, and also understanding how donors can operate in the short to medium term whilst such capacities are being put in place. Are there specific areas such as information asymmetries and the supply of public goods that donors are well positioned to address through the private sector?

v) **Donors must be realistic on the capacity of the private sector.** Too often there is an assumption that when the environment in place, the private sector will flourish. However, the private sector in developing countries is often weak, markets are very thin, and firms are unable to respond, innovate and invest in new ventures that bring the poor into markets. Whilst these things would eventually happen, is there a role to catalyse, facilitate, incentivize and speed up the development of markets where there are particular pro-poor benefits?

vi) **Greater attention needs to be paid to how donors can engage with the private sector to improve the functioning of markets**. Donor assistance to the private sector may distort markets and cause donor dependency. Whilst some of the worst excesses of the past have been addressed, donors still need to find innovate tools, instruments and approaches of working with the private sector that helps to strengthen, rather than undermine, the functioning and fairness of markets. MMW4P represents one promising instrument.

[i] This is note 2 in a series of 6: note 1 addresses MMW4P: Contributing to Growth & Poverty Reduction; note 3 The MMW4P Framework; note 4 the Market System; note 5 MMW4P Programme Implementation; note 6 Lessons Learnt.

[ii] Dorward, Andrew and Nigel Poole. 2003. 'Markets, Risks, Assets and Opportunities: the link between the functioning of markets and the livelihoods of the poor'. *Proceedings of the MMW4P Inception Workshop.* Hanoi: Asian Development Bank.

[iii] In the developing countries, just over half the growth recorded has come from increases in the stock of factors of production with the rest due to gains in productivity.

[iv] Employment and Development: A multi-sector approach to foster job creation, poverty reduction and growth. *A Policy Note by Social Protection & Labor Department, World Bank*

[v] FinMark is a DFID programme addressing access to finance in Southern Africa. ComMark addresses commodity markets in Southern Africa. Katalyst is a joint Swiss Agency for Development Cooperation, Sida and DFID programme addressing rural livelihoods and urban employment in Bangladesh.

[vi] Growth Diagnostics, Ricardo Hausmann, Dani Rodrik, Andrés Velasco (2004)

[vii] See above.

[viii] Improved fiscal and monetary policy is needed to reduce the incentive for commercial banks to invest in relatively low risk treasury bills as opposed to lending to the private sector.