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A Conceptual Framework for Designing a Country Poverty Reduction Strategy

RONALD DUNCAN and STEPHEN J POLLARD

Ronald Duncan is a professor at the Australian National University, and Stephen J. Pollard is a senior economist (Poverty Reduction) at the Asian Development Bank. This paper is to be delivered at the ***Asia and Pacific Forum on Poverty: Reforming Policies and Institutions for Poverty Reduction***, to be held at the Asian Development Bank, Manila, 5-9 February 2001.

Introduction

The Bank's Poverty Reduction Strategy was approved by the Board in November, 1999. The strategy calls for the formulation of Country Operational Strategies "on the basis of the priorities emerging from the poverty analysis and the high level forum. The Strategy will provide the analysis and set out the areas of focus, including policy reforms and sector emphases. It will also take into account the comparative advantage of ADB and the programs of other agencies (ADB 1999)."

But how should ADB select priorities for assistance to member countries, while giving priority to the poverty reduction objective? Should ADB finance airports, roads, shipping, and other means for improving market and service access for the poor? Or should ADB invest in health clinics, schools, and other forms of human capital development? Or should ADB fund natural and rural development activities, SME development, and micro-finance schemes to raise the incomes of the poor? According to Stiglitz (1998), "technical solutions (to development) were evidently not enough" and "an economy needs an institutional infrastructure." What are institutions and which ones should have priority?

Certainly, there is need for improving project selection. After a review of projects that are funded by international agencies and bilateral donor agencies, the Development Assistance Committee of the OECD (DAC 2000) concluded: "There is very little evidence that the projects have been particularly helpful, or effective, in reducing poverty. Studies of project experiences have few successes to report. As few as only one in five projects combating poverty can be characterized as highly targeted at the specific issues which in combination define the situation of the poor. Few project interventions are sustainable when donor funding ceases. Successful projects are hard to replicate." How can ADB projects be better grounded within an overall country program, policy, and institutional framework that will assist in rapidly reducing poverty?

Poverty Analysis before Strategy Design

Governments and donors have increasingly turned their attention and activities, and in some cases declared a total commitment, to poverty reduction. Some have published manuals,¹ guidelines,² strategies,³ and handbooks⁴ in support of the provision of assistance to reducing poverty. An outcome of all of this activity has been a focus on what is now called poverty analysis. Such analysis is primarily concentrated on describing the poor within a society: estimating how many there are, and defining them in terms of location, occupation, gender, age, health, and access to assets, markets, and public services. There has been much less emphasis on gaining an understanding of *why* they are in this state and why they have poor access to income-earning assets such as land, credit, education, and health, as well as poor access to markets.

However, the situation is changing and much more attention is being given to asking why the poor are not participating in economic growth. In many cases, development assistance is dealing with mass poverty, i.e., instances in which a large proportion of people is in absolute poverty or perilously close to it. In such cases it seems that describing poverty in great detail should not have high priority; rather, the emphasis should be on understanding the constraints to the people contributing to economic growth. If most people are poor, it is clear that the most important resource of the economy, i.e., its people, is being underutilized. It also appears irrelevant in such cases to be debating whether the focus of development should be on promoting economic growth or on reducing poverty.

Approaching development in terms of asking why the poor are not being involved in the growth process is a clear break from the approach that dominated development assistance in the second half of the 20th Century. To understand how thinking about development has changed,

¹ Aho, Lariviere, and Martin (1998).

² DAC (2000).

³ ADB (2000).

⁴ The World Bank (1993).

it is helpful to review briefly the recent changes that have taken place in the way that development theorists and practitioners have approached development assistance.

Recent Changes in Thinking about Development

During most of the latter half of the 20th Century, the dominant view among development theorists and development assistance agencies was that people and countries were poor because the countries did not have sufficient capital. Therefore, it was argued, the path to economic growth and development was to transfer capital from the richer countries. It is only recently that there has been a wider understanding that countries lack capital and are poor because they are very unfriendly places for capital (both physical and human capital). It is interesting, therefore, to trace how thinking about the development process has changed over the past 50 years, both in terms of economic theory and in terms of practice within development agencies. However, the change has been a two-way process, with practical experience being reflected in the development of theory, and theoretical developments reflected in changes in the forms of development assistance.

Early mainstream Western ideas about what was important in the economic growth process were dominated by what has become known as the Solow-Swan neo-classical model of growth (Solow 1956). Briefly, this model assumes a single output, produced using labor and capital in a constant-returns-to-scale technology with diminishing, and eventually exhausted, marginal returns to each factor. The model predicts that long-run growth rates of per capita income will equal the (assumed) exogenous rate of technical progress. Changes in savings rates or government policies will affect the levels of steady-state output and capital stock but will have no long-run effect on the growth rate. If all countries experience the same rate of exogenous technical progress, they will all converge to a common growth rate over time. Countries with different savings behavior, institutions, cultural norms, government policies, and so on, may be expected to have different levels of steady-state income and different capital-labor ratios, but their long-run growth rates would all be anchored to the common rate of technical progress.

Thus, this model, which was developed with the industrial countries in mind, placed emphasis on physical capital, undifferentiated labor, and technical progress. In early empirical applications to high-income countries, accumulations of physical capital and labor accounted for only about 25 percent of historical growth. The balance ("residual") was attributed to technical change. There were arguments over whether the technical change was "embodied" in the physical capital or whether it was exogenous, "autonomous," or "disembodied."

This theory sat well with the prevailing approach to development assistance at a practical level, which was that countries were poor because they lacked physical capital to go with their abundant labor. Therefore, the principal role of development assistance was to transfer financial capital from the richer countries to the poorer countries, where it would be transformed into physical capital, largely in the form of public infrastructure. Technical change was to a large extent seen as being transferred as "embodied" in the physical capital. Thus there were arguments over the appropriateness of the technology transferred in this way. This approach to development probably received support from the success of the Marshall Plan in the rapid recovery of western Europe after the devastation of the Second World War. The Marshall Plan's success was essentially seen as the result of the successful transfer of capital to those countries.

The next major change in thinking about the process of economic growth can be seen to grow out of the work of Becker (1964). Becker argued that all labor was not the same, that it was differentiated through education, training, and improvements in health, and that household decisions about these investments in labor could be thought of in an economic framework of human capital. The insights from Becker's household consumption model were soon picked up by the development assistance agencies in the form of projects on education and health. Only later (Mankiw, Romer, and Weil, 1992) were the ideas captured in the economic growth literature by showing that the predictions of the neoclassical model attribute much less importance to the residual if the definition of capital is widened to include human capital.

In the late 1970s there was another major change in development thinking which seems to have grown out of two pieces of empirical research. First, Krueger and Bhagwati's study of the rapid growth of the four "East Asian Tigers" (see Krueger 1978) highlighted the importance of policy, particularly openness to international trade and investment. The corollary to their research was that the import substitution policies that had been carried on by most if not all poor countries were not favorable to long-term economic growth.⁵ There can be rapid income growth in the early stages of an import substitution strategy as the protected firms expand in capturing the domestic market. However, being internationally uncompetitive, when they saturate the domestic market, income growth slows as the protected firms are unable to export.

The second major jolt to development thinking came from the World Bank where an evaluation of the Bank's completed projects showed that many of them were failures, particularly in the poorest countries in sub-Saharan Africa. The conclusion reached—most likely with the Krueger/Bhagwati research in mind—was that the projects were unsuccessful because the policy environment was unfavorable. Thus developed the concept of the Structural Adjustment Program and "conditionality," with the emphasis on changing the policy regime so that countries were more open to trade and investment, both internally and externally. The focus on "getting the prices/policies right" was expanded to include macro-economic policies (which were the focus of the IMF) as well as micro-economic policies (more the focus of the World Bank and the regional banks). Agreement on this approach to development assistance became known as the "Washington Consensus."

The focus of development assistance on policies was reflected in the economic growth theory with the development of the so-called "endogenous" growth models in the late 1980s and early

⁵ The popularity of import substitution policies can be traced to the early success of the "heavy industry" policy of the former Soviet Union (and later the People's Republic of China)—especially during the 1930s when there was such a sharp contrast between the economic performance of the Soviet Union and the Great Depression experienced in the capitalist countries—and later to the writings of Prebisch (1950) and Singer (1950) who saw the need for import substitution strategies to counter what they saw as the exploitation of the primary-producing poor countries by the industrialized countries.

1990s. In these models, technical change is endogenous, an idea that appealed because it could help explain how countries could keep growing at faster rates over long periods, rather than moving towards some static growth rate as in the neoclassical model. An alternative to expanding the capital stock in the neoclassical model is to assume that there are externalities to capital which can spill over to the whole economy and increasing returns to scale such as through “learning by doing” (Romer 1986, Lucas 1988) or research and development (Romer 1990). For example, in the differentiated-inputs model of Romer (1990) and Grossman and Helpman (1991), growth is faster the larger the scale of the research and development sector. Another implication of external effects and increasing-returns models is that these effects justify government intervention, and such permanent changes in government policy can have permanent effects on the growth rate.

While the focus on the policy environment dominated development assistance efforts in the 1980s and 1990s, changes in the paradigm were underway, stemming from North’s (1973, 1990) early focus on the important institutions of an economy. North’s work has been given a more practical flavor with the writings of Olson (1996 and 2000) and de Soto (2000). The key idea of this work is that of the overriding importance for economic growth of the basic institutions—public and private, formal and informal, and economic, social, and political—that determine how an economy functions. In this literature, “institutions” have a particular definition, distinct from the common use that is indistinguishable from “organizations.” Haggard (1999) describes the difference as follows:

Institutions refer to the formal and informal rules and enforcement mechanisms that influence the behavior of organizations and individuals in society. They include constitutions, laws and regulations, and contracts, as well as trust, informal rules and social norms. Organizations are collective social actors, usually characterized by hierarchical patterns of internal authority, that pursue common interests. Organizations operating in the public sphere include government bureaucracies, legislatures, political parties, unions, interest groups, NGOs, and even firms in their political capacities.(p.30)

In particular, de Soto (2000) has shown that “getting the policies right” (the focus of the Structural Adjustment Programs) will be ineffective unless the institutions essential to the participation of all of an economy’s income-earning assets (land, labor, capital, and natural resources) are in place. Referring mainly to land and other forms of fixed capital, he says:

Most people cannot participate in an expanded market because they do not have access to a legal property rights system that represents their assets in a manner that makes them widely transferable and fungible, that allows them to be encumbered and permits their owners to be held accountable. So long as the assets of the majority are not properly documented and tracked by a property bureaucracy, they are invisible and sterile in the marketplace. (pp.210-1)

Institutions are essentially the sets of rules that govern how a society behaves in particular areas of activity. As North (1990) describes them, they range from taboos, customs, and traditions in what are called traditional societies to formal, written constitutions and laws governing economic, political, and social behavior in a more modern society. Institutions may be formal—such as a constitution or traffic laws—or they may be informal, such as voluntary codes of conduct of business or social groups. The set of rules making up an institution defines the incentives to which people will respond. According to North (1990) and Hayami and Ruttan (1971), institutions change as the transaction costs of behaving in certain ways change. Transaction costs can be seen to change as economies develop and technologies improve, and as political and social forces within a society change. So, for example, reductions in transport costs—of information or goods—can make certain behaviors more or less costly, and therefore lead to a new form of institution. Or increased trust between individuals and groups can not only improve social cohesion but also lower the costs of transacting contracts.

North emphasized the cost of information in the development of institutions. The provision and communication of information is required to measure the attributes of a good or service in economic exchange and to define and protect the rights that are exchanged. The more costly

are the exchange and its enforcement, the higher are the transaction costs, and the less likely is the institution to exist or to be effective.

North (1990), Olson (1996), and de Soto (2000) have stressed the overriding importance of property rights and contract enforcement in economic growth. Well-defined and secure property rights and impartial enforcement of contracts between parties are the basis for a market economy. If individual rights to factors (land, labor, or capital) are ill-defined in legislation and all contracts made between parties to an economic exchange are not impartially enforced by the judicial system—and therefore both property rights and contracts are free from discretionary intervention by politicians and bureaucrats—then the costs of transactions and the costs of transformation in production will make economic activity infeasible or highly sub-optimal. In such circumstances, people will be reluctant to invest in fixed assets. The only businesses that will exist will be those that are “footloose,” i.e., easily shifted to another location. Or private economic activity will only be undertaken with some kind of government guarantee (such as joint ventures with government, where the government will likely bear the business risks involved; or where higher profits to cover the high transaction and transformation costs are assured, such as through some form of import protection). In such circumstances the economic activity may be largely illegal and small-scale, and bribery of government officials frequent, as de Soto (1989) has shown. People will also be unwilling to invest in education, or will only do so if they have prospects of moving to another country where they will be able to earn and retain an income that justifies their investment.

Olson (1996) and de Soto (2000) explain the large and growing gap in incomes between the rich countries and those poor countries where incomes have grown very slowly, if at all, as largely due to the absence of these basic institutions, not to the lack of capital, some inherent deficiency in work ethic, or some culturally-determined behavior. Prior to its break-up the former Soviet Union had the highest per capita level of education in the world, as measured in terms of the level of schooling reached, and the highest per capita level of plant and machinery. But it

remained a poor country. What it lacked was the institutions that allow entrepreneurship and innovation to flourish through effective economic transformation and exchange.

Olson (1996) demonstrates the critical importance of secure property rights and impartial enforcement of contracts. He points out that if the key missing ingredient for development was capital, then the marginal productivity of capital would be higher in poor countries than in rich countries, and private capital would be trying to move from rich to poor countries. In fact, the movement is strongly in the other direction as we see from estimates of "capital flight." Similarly, Olson argues that institutions in the rich countries must be the missing ingredient when an individual can migrate from a poor country to a high-income country and soon thereafter earn an income that is many times higher than in their home country and as high as or higher than the average income in the host country. The plane flight does not change migrants' skills and willingness to work as much as it places them in a more friendly environment for their labor and capital (no doubt what applies to labor and capital also applies to technology).

De Soto (2000) has dramatically highlighted the lack of an effective system of private entitlement to land and other income-earning assets in poor countries and how this inhibits the development of economic activity, particularly through inhibiting the creation of capital by the poor. He estimates that the total value of land and other assets "owned" by the poor in developing countries is around US\$9.3 trillion, many times the value of foreign aid or foreign investment. Yet, without the possibility of efficient transfer of these assets, or the ability to use these assets as collateral in order to raise capital (securitization), the assets have little income-generating power. Only where there is an effective system of property law can the value of land or other assets be properly established; can they be easily bought and sold; or can they become collateral so that the wealth can be mobilized in investment capital. Without such property rights, and the possibility of securitization of assets, there can never be an effective capital market.

The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house.

By contrast,

The poor inhabitants of these nations [Third World and former communist countries] – five-sixths of humanity—do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation. It is the unavailability of these essential representations that explains why people who have adopted every other Western invention, from the paper clip to the nuclear reactor, have not been able to produce sufficient capital to make their domestic capitalism work (de Soto 2000:6-7).

Aron (2000) sums up the institutional constraints in poor countries as follows:

When institutions are poorly defined or there are few formal institutions, economic activities are restricted to interpersonal exchanges. In such cases, repeat activities and cultural homogeneity facilitate self-enforcement. Transaction costs may be low in such an environment, but transformation costs are high because the economy operates at a very low level of specialization. Economic exchange also could operate at one remove, via social networks, but contracts are still constrained by kinship ties. It is clear, however, that firms or agents in an environment of weak institutions cannot engage in complex, long-term, and multiple-contract exchanges with effective enforcement as they do in industrial economies. A basic structure of property rights that encourages long-term contracting appears essential for the creation of capital markets and growth. (p. 105)

While there are many countries where the poor own assets but have no excisable property rights, there are circumstances where the poor do not have any access to potential income-

earning assets such as land or even education. In these latter circumstances there has to be some form of asset redistribution or asset creation.

It is not easy for a country to make the substantial changes in institutions or asset redistribution necessary to allow the poor to participate in economic growth and development. The new institutions and land redistribution that established a basis for rapid income growth in Japan, Republic of Korea, and Taipei, China was imposed by external forces. In People's Republic of China and in Viet Nam, which experienced revolutions in agricultural productivity through the changeover from collectivization to individual land rights (leasehold) and the liberalization of agricultural markets, the transformations in institutions were introduced internally but were exceptional in their breadth and speed. As North and Olson have argued, changing the *status quo* may be very difficult or even impossible without such dramatic intervention, because the vested interests benefiting from the existing situation usually hold political power and therefore have no interest in change. The important question therefore is how to stimulate change in such circumstances.

The 1990s has seen a large degree of attention given by the development community to "governance." This focus grew out of the concerns of the World Bank and bilateral donors with corruption in the governments of borrowing countries and the desire by non-political organizations like the World Bank to be publicly critical about corruption. As interest in governance has grown, the scope of its definition has broadened. Early on, concerns about governance were mainly focused on the accountability and transparency of government and the political process, and the effectiveness of the government's fiscal and monetary policies.

Following Burki and Perry (1998), Haggard (1999) defines governance as "the design of institutions and organizations for making and implementing collective decisions." Broadening the focus of governance from what may be thought of as "good government" to include the establishment and operation of the basic institutions for the operation of an economy may be helpful in the sense that it places emphasis on these basic institutions. However, if the concept

of governance becomes so all embracing it may be less helpful. It may be more useful to keep “good government” issues separate, while recognizing that the form of institutions will have an impact on the effectiveness of government.

Economic theorists are incorporating the role of institutions within the economic theory of growth and there is burgeoning empirical research on the relationship between institutional development and economic growth (see Aron 2000 for a review). Development agencies are beginning to focus on institutional issues. But there is not yet a full commitment to the conclusions that are implicit in de Soto’s work. In other words, if basic institutions for the creation of capital and full participation of the whole society in economic activity are not in place, investments in infrastructure, education, health, or economic reforms, or public sector reforms will not be effective, and will likely only increase income inequality—favoring those who already have access to factor markets. Building roads and bridges or undertaking agricultural research will not increase incomes as much as they could if people do not have secure property rights to farm land; education and health improvement projects will not promote income growth for the poor unless there is the generation of capital with which the healthier and better educated labor force can work; privatization of public enterprises will be less than fully effective if there are not secure property rights to land and enforcement of contracts; laying off public officials with redundancy packages could see them become the new entrepreneurial class but won’t if they cannot gain secure access to land and raise additional capital through securitization of their assets; and trade and investment policy reform will see disappointing results in the form of supply responses unless there is security of property rights and contracts and capital markets are developed so that traders can raise capital and hedge their commodity and currency risks.

Therefore, in going about their business, particularly to ensure economic growth in which all will participate, development agencies have to have a fundamental re-examination of the prospects of success for their traditional forms of lending and aid. They have to examine whether there are appropriate institutions in place so that investments have a good chance of being successful. They also have to evaluate the possibilities for assisting the creation and

redistribution of income-earning assets within a country so that the poor have the chance to participate more fully in the growth process. To carry out this evaluation, development assistance agencies have to be able to define more clearly the constraints impeding participation by the poor and place priorities on the removal of these constraints. We suggest below a framework within which to examine the constraints to the success of development lending. This approach can also provide a framework for the prioritization of assistance in a poverty reduction strategy.

A Conceptual Framework

Generally, where mass poverty persists, countries have experienced little or no economic growth. This lack of growth should not be surprising since the country's most important resource, its people, is not able to generate much income. In some cases, there may be economic growth but it is shared among a favored few. This is often the case where mineral or oil deposits are exploited in enclave activities. In these cases, forward and backward linkages within the economy are few. In other cases, a few favored industrial activities, operating under an umbrella of tariffs or some other form of government-guaranteed income support, may be generating high incomes for those involved in the activities. Again, the likely result is high and increasing income inequality. In all cases, the key question should be: why are the assets of most people unable to generate the levels of income that they generate in high-income countries?

The figure below provides a framework within which to think about the constraints on peoples' activities, and on the effectiveness of investment and aid, and thereby helps prioritize planned interventions in support of poverty reduction. Going from the top of the figure to the bottom is, in a sense, like peeling away the layers of covering to find out what is at the core. So the figure is designed to be read from the bottom up. The central goal of the strategy is poverty reduction, and the objective of the exercise is to identify where, along the path from civil and social order to

poverty reduction, the constraints to effective participation of people in the growth process lie. The assumption is that constraints have to be overcome from the bottom up.

To the immediate left of the central boxes or goals are listed the institutions that have to be in place and working effectively for the particular goal to be achieved. To the immediate right are policies that can be carried out effectively when that central goal has been achieved or policies that influence how well the goal is achieved. To the far right of the figure is noted the length of time that it is expected will be needed to achieve those goals (short-term, medium-term, or long-term). To the far left of the figure is shown whether generally rising incomes can be expected, given institutional or other constraints. Economies not generating “quality” growth, i.e., growth in which most in society participate, are likely to have constraints at the bottom of the figure.

Working from the bottom of the figure to the top we see that without civil order there can be no economic development. Where civil and social order has not been established, it is likely that only intervention in the form of humanitarian aid can be helpful. Efforts to implement infrastructure or other investment projects in countries where a stable environment of civil order has not been established—as in several sub-Saharan Africa countries over recent years—has yielded a frustrating history of stop-start development assistance, with total failure of the assistance as the usual outcome. Important institutions that have to be in place for the maintenance of civil and social order are the police and the judiciary. As well, self-policing by the community—in the sense that there needs to be a degree of trust and concern for others—is also important in the maintenance of civil order. A constitution and a body of common law or custom will also be necessary to codify the rights of members of the society.

The next building block that has to be put into place comprises the institutions that form the basis for a market economy, i.e., property rights and impartial enforcement of contracts, as well as informal institutions such as codes of conduct. For these institutions to be effective, the judicial system will have to be working effectively, in particular without intervention by politicians or the bureaucracy. Trust within the society is also an important ingredient in the effective

workings of property law and contracts. If there is not a substantial degree of trust between parties involved in contracts, the load on the judiciary in resolving contract disputes will make the system unworkable, i.e., the transaction costs will be too high for the institution to function.

The next building block is good governance. If the broader definition of governance were adopted, i.e., to include institutions and organizations as well as “good government” matters, there would be a single governance block. As said earlier, it is a good idea to separate institutions and governance as a separation forces a focus on the basic institutions necessary for a market economy to function well. To have good governance, there needs to be political stability. This stability will depend on the effectiveness of the electoral system and the constitution, as well as checks and balances that operate through the media and community groups, and perhaps supra-government or supra-parliamentary bodies that have power to monitor government behavior (such as administrative tribunals and an ombudsman). The main policies that will be affected by the state of governance are fiscal and monetary policy. These policies in turn will determine exchange rate policy and the inflation rate.

If they are not already in place, establishing civil and social order, effective market institutions, and good governance will usually take a considerable length of time, and without these building blocks in place there will be no, or very limited, growth in incomes. Therefore, a poverty reduction strategy will have to give prior attention to what may be done in the short to medium term that may assist in bringing about desirable changes. To gain an understanding of any shortcomings in these areas, it will likely be necessary to undertake detailed cultural, social, and political economy studies to gain the required information about the society before recommending any action. One issue that will be important in bringing about change will be to find ways to promote widespread “ownership” of desirable reforms.

The next building block for effective development assistance is effective factor and output markets. Secure property rights and contract enforcement are the basis for effective factor and output markets; however, for effective markets there has to be effective regulation to ensure

freedom of entry and thereby avoid anti-competitive pricing, and ensure provision of quality goods and services and health and safety standards. The development of factor markets that are open to participation by all, and do not discriminate in terms of gender, ethnicity, religion, etc., is fundamental to the exploitation of a country's comparative advantages and having inclusive economic growth.

Secure individual title to land (whether through long-term lease or freehold) appears to be a pre-requisite for the rapid growth of poor countries and their development into modern economic systems. Secure title to land is necessary for people to have confidence in making the fixed investments that lead to increased productivity. Without such security, private investments are likely to be confined to those having a government guarantee of some kind (such as a joint venture with government), or be "foot-loose" industries that will exit when there is a contract dispute, or be exploitative (such as "high grading" in mining or logging). As has been dramatically demonstrated in People's Republic of China and Viet Nam in recent years, providing farmers with secure, long-term tenure to land has led to remarkable agricultural growth. The absence of such rights in many other countries provides clear counter examples.

Secure, individual title to land is also the basic requirement for the development of a financial sector, as without land as security for loans, creditworthiness is difficult to establish. The result will be the locking-up of assets and savings that de Soto (2000) highlights in poor countries.

As populations grow, secure access to land for agricultural purposes becomes a less likely avenue through which people can participate in the growth process. Good health and education (human capital) have become the main income-generating assets for most people in today's knowledge-driven world. Moreover, while land redistribution and secure rights to land may be able to play some role in increasing the poor's access to income-earning assets, land redistribution is extremely difficult to achieve, while education can be a much more easily achieved and even more productive route to higher incomes. However, there will need to be secure title to land as the base for all productive agricultural, industrial, and services activities.

Provision of the opportunity for all to be educated and free of debilitating infections and disease will allow all in society to participate to the full in the labor market. For the labor market to be fully effective in mobilizing labor there should be no discrimination on the basis of gender, ethnicity, religion, etc. Moreover, care should be taken to see that the public sector does not become a wage leader to the detriment of the private sector, which often happens when the economy is heavily dependent on aid and/or natural resource rents. Minimum wage legislation may be seen as essential as a social safety net; however, if the minimum wage exceeds the productivity level of unskilled labor, it will become an impediment to the employment of the poor.

With these building blocks in place, investment should be effective in promoting economic growth, and particularly growth in which all can share—providing that policies directly affecting investment are not restrictive. Experience has shown that policies that place few restrictions on domestic and foreign investors and on trade within and between countries are favorable to growth. Moreover, openness to trade and investment will serve as an effective means of preventing monopolistic behavior by firms. However, there may still need to be legislation outlawing anti-competitive behavior. Competition policy should also provide for competitive access to natural monopolies in essential services such as power, water, and transport.

Conclusion

After more than four decades of development assistance and nearly 20 years of concentrated effort by international development agencies and individual country donors on encouraging economic reforms in developing countries, the limits to development assistance have become much clearer. We now have a much better idea of what is absolutely necessary for success and what is important but secondary; and we have a much better idea of the appropriate prioritization and sequencing of economic reforms and forms of assistance in support of poverty reduction.

It is now abundantly clear that the paradigm that dominated development assistance activities for most of the past 40 years—that the main constraint to economic development was a shortage of capital—was unhelpful. Capital is scarce in developing countries, but it is scarce because the environment is not friendly towards capital, whether private or public capital. The poor investment environment led some to argue in favor of direct public sector investment. But it has also been learnt at great cost that government activity in production is seldom an adequate substitute for private sector activity. In order to mobilize an economy's resources and for a flourishing private sector to develop—one that can be a sound basis for raising the needed government revenue—the basic institutions of secure property rights, impartial enforcement of contracts, and internationally-accepted codes of commercial conduct have to be in place. In turn, these institutions depend upon a legal and judicial system that is allowed to function without interference, and a government and bureaucracy operating in a transparent, accountable, and fully accessible manner.

Secure property rights and impartial enforcement of contracts are the basis for a market exchange economy and thus for all private sector activity, which is now recognized as the engine of growth and the main means of doing away with absolute poverty. But security of property rights and impartial enforcement of contracts, in the broadest sense of the state providing security over the income from one's labor, capital, and land, has even broader implications. It provides equality of opportunity for all and thus is protective of the rights of all individuals, regardless of gender, ethnicity, or religion.

Secure property rights for labor, ensuring freedom from discrimination, also ensures maximum flexibility in labor markets. On the one hand, firms should not be forced to pay wages that are not in line with the productivity of labor. On the other hand, labor should be rewarded for its productivity and provided the necessary scope to realize its potential through training. This approach will ensure that real wages are based on productivity, which in turn will maintain competitiveness in international markets.

While governments may be keen to implement these kinds of measures, it is clear that there will often be resistance from groups or individuals benefiting from the status quo. If these groups or individuals are in a politically powerful position, reforms may well be stifled. The major issue in these instances is how to bring about change from the status quo.

Demand for changes to institutions and policies can be fostered by actions that increase the value to the community of new institutions and policies. In particular, demand for more secure and impartially enforced property rights may be fostered by freeing up trade and investment, and by appropriate investment in human and physical capital. Freeing up trade and investment can raise the implicit rental value of land and future income streams from labor. Investment in physical infrastructure such as roads, ports, telecommunications, and essential services will also raise the implicit rental value of land and future labor incomes. Investment in a better-educated and healthier population will do likewise. Social mobilization through political parties, labor unions, and consumer groups can also help to bring about change through countervailing power. While change will usually be very difficult to achieve, it may be possible to take measures that will ease the constraints in the short run. For example, in the short run it may be possible to have regulations repealed that limit informal sector activity and therefore restrict income generation by the poor.

Change in the distribution of rights to land use may be even more difficult to achieve than change in institutions. But access to land may have become less important to improving the standard of living of people than previously. In an increasingly knowledge-driven world, education may be a more important income-earning asset and increasing access to education may be easier to achieve than access to land.

These measures should be seen as mutually reinforcing. Trade or investment reform without secure property rights and contracts will see little response in the form of outward-oriented, growth enhancing investment. Similarly, public expenditure on education and health or on physical infrastructure will give little return without the presence of the institution's basic to

private sector development. On the other hand, public sector reform in the form of public service cutbacks or privatization of state-owned enterprises will not promote demand for better economic institutions but will only be effective if they already exist. Security of contracts requires an impartial judiciary, i.e., free from political and bureaucratic intervention. However, security of contracts also requires widespread trust to minimize contract disputes and the need for the courts to intermedicate. Trust is an important outcome of the social capital of a country. Where the degree of trust is poor, contract disputes can be expected to be widespread and the transaction costs of contracts high.

Development assistance agencies can help countries move towards commitment to these measures through technical assistance that demonstrates the benefits of better institutions and policies and participatory discussion of the pros and cons of various measures and alternatives. Experience has also shown that high-level training of local people is very effective in leading to ownership of these growth enhancing measures. For those countries where there is no or very little interest in undertaking these measures, such technical assistance and training may be the only worthwhile development assistance to provide until there is a change in attitudes of those in power or of the community more broadly. Lack of ownership of reforms will only lead to their failure and often leads to unnecessary social hardship and tension, and thereby provides arguments for not making similar attempts in the future.

If the restrictions preventing the poor from participating fully in economic growth are removed, monetary and fiscal policies, and other policies such as trade and investment policies, should be much less discriminatory in their impacts. This removal of restrictions does not mean that all people will do equally well out of economic growth, as people will have different levels of access to assets. Moreover, there will still be a need for the government through its fiscal policy to try to ensure equal access to a basic level of essential services and to have in place redistribution policies that provide a safety net for people. The government's capacity to provide social security will ultimately depend on its taxation base. However, the government does have a degree of discretion in where it locates public investment. Therefore, it is able to discriminate in

favor of areas that are disadvantaged in terms of transport or other infrastructure, education, and health. However, the extent of discretion is limited by the trade-offs that will have to be made between promoting maximum use of the country's comparative advantage and assistance to disadvantaged areas.

The Bank's approach to designing poverty reduction strategies should be derived from the fullest understanding of the development process and the appropriate role for development assistance, realizing that understanding of the process is continually improving. It is desirable to strive for agreement among the government, other multilateral agencies, and bilateral donors on the best strategy for achieving inclusive economic growth. Moreover, in order for any strategy to be effective, there will need to be broad ownership of the strategy within the country. However, it has to be recognized that it is unlikely that there will ever be full agreement with any strategy, as there will always be room for healthy debate.

At some point, however, ADB will have to decide on the country strategy that it believes should be followed and the role that it should play in the strategy, and work with the government on implementing its activities. Effective implementation is often much more difficult than the design of programs and policies. In large part, effective implementation will depend upon the effectiveness of the country's governance and its capacity to undertake and sustain programs. Judgements will therefore have to be made about the likelihood of success of the program. In some cases the judgement may be that the likelihood of success is low and therefore ADB should restrict its activities in the country to technical assistance and information dissemination aimed at improving the environment for future action.

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Figure 1

