

GROWTH

BUILDING JOBS AND PROSPERITY IN DEVELOPING COUNTRIES

Introduction

Economic growth is the most powerful instrument for reducing poverty and improving the quality of life in developing countries. Both cross-country research and country case studies provide overwhelming evidence that rapid and sustained growth is critical to making faster progress towards the Millennium Development Goals – and not just the first goal of halving the global proportion of people living on less than \$1 a day.

Growth can generate virtuous circles of prosperity and opportunity. Strong growth and employment opportunities improve incentives for parents to invest in their children's education by sending them to school. This may lead to the emergence of a strong and growing group of entrepreneurs, which should generate pressure for improved governance. Strong economic growth therefore advances human development, which, in turn, promotes economic growth.

But under different conditions, similar rates of growth can have very different effects on poverty, the employment prospects of the poor and broader indicators of human development. The extent to which growth reduces poverty depends on the degree to which the poor participate in the growth process and share in its proceeds. Thus, both the pace and pattern of growth matter for reducing poverty.

A successful strategy of poverty reduction must have at its core measures to promote rapid and sustained economic growth. The challenge for policy is to combine growth-promoting policies with policies that allow the poor to participate fully in the opportunities unleashed and so contribute to that growth. This includes policies to make labour markets work better, remove gender inequalities and increase financial inclusion.

Asian countries are increasingly tackling this agenda of 'inclusive growth'. India's most recent development plan has two main objectives: raising economic growth and making growth more inclusive, policy mirrored elsewhere in South Asia and Africa.

Future growth will need to be based on an increasingly globalised world that offers new opportunities but also new challenges. New technologies offer not only 'catch-up' potential but also 'leapfrogging' possibilities. New science offers better prospects across both productive and service sectors.

Future growth will also need to be environmentally sustainable. Improved management of water and other natural resources is required, together with movement towards low carbon technologies by both developed and developing countries. With the proper institutions, growth and environmental sustainability may be seen as complements, not substitutes.

DFID will work for inclusive growth through a number of programmes and continues to spend heavily on health and education, which have a major impact on poor people's ability to take part in growth opportunities.

More and better research on the drivers of growth will be needed to improve policy. But ultimately the biggest determinants of growth in a country will be its leadership, policies and institutions.

1. WHY GROWTH SHOULD BE AT THE HEART OF DEVELOPMENT POLICY

'Historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom.'

Dani Rodrik, Harvard University

One Economics, Many Recipes: Globalization, Institutions and Economic Growth
(2007)

The central lesson from the past 50 years of development research and policy is that economic growth is the most effective way to pull people out of poverty and deliver on their wider objectives for a better life.

Growth helps people move out of poverty

Research that compares the experiences of a wide range of developing countries finds consistently strong evidence that rapid and sustained growth is the single most important way to reduce poverty. A typical estimate from these cross-country studies is that a 10 per cent increase in a country's average income will reduce the poverty rate by between 20 and 30 per cent.¹

The central role of growth in driving the speed at which poverty declines is confirmed by research on individual countries and groups of countries. For example, a flagship study of 14 countries in the 1990s found that over the course of the decade, poverty fell in the 11 countries that experienced significant growth and rose in the three countries with low or stagnant growth. On average, a one per cent increase in per capita income reduced poverty by 1.7 per cent (see Figure 1).²

Among these 14 countries, the reduction in poverty was particularly spectacular in Vietnam, where poverty fell by 7.8 per cent a year between 1993 and 2002, halving the poverty rate from 58 per cent to 29 per cent. Other countries with impressive reductions over this period include El Salvador, Ghana, India, Tunisia and Uganda, each with declines in the poverty rate of between three and six per cent a year.

Driving these overall reductions in poverty was the rebound in growth that began for most of the countries in the mid-1990s. The median GDP growth rate for the 14 countries was 2.4 per cent a year between 1996 and 2003.

Numerous other country studies show the power of growth in reducing poverty:

¹ See, for example, Adams, R (2002) *Economic Growth, Inequality and Poverty: Findings from a New Data Set*, Policy Research Working Paper 2972, World Bank, February 2002, and Ravallion, M and S Chen (1997) 'What Can New Survey Data Tell Us about Recent Changes in Distribution and Poverty?' *World Bank Economic Review*, 11(2): 357-82

² Operationalising Pro-Poor Growth (OPPG) Programme (2005), 'Pro-Poor Growth in the 1990s: lessons and insights from 14 countries'

- China alone has lifted over 450 million people out of poverty since 1979. Evidence shows that rapid economic growth between 1985 and 2001 was crucial to this enormous reduction in poverty.³
- India has seen significant falls in poverty since the 1980s, rates that accelerated into the 1990s. This has been strongly related to India's impressive growth record over this period.⁴
- Mozambique illustrates the rapid reduction in poverty associated with growth over a shorter period. Between 1996 and 2002, the economy grew by 62 per cent and the proportion of people living in poverty declined from 69 per cent to 54 per cent.⁵

Growth transforms society

The positive link between growth and poverty reduction is clear. The impact of the distribution of income on this relationship – in particular, whether higher inequality lessens the reduction in poverty generated by growth – is less clear.

Initial levels of income inequality are important in determining how powerful an effect growth has in reducing poverty. For example, it has been estimated that a one per cent increase in income levels could result in a 4.3 per cent decline in poverty in countries with very low inequality or as little as a 0.6 per cent decline in poverty in highly unequal countries.⁶

Such calculations need to be interpreted with care given the multitude of variables involved. Even if inequality increases alongside growth, it is not necessarily the case that poor people will fail to benefit – only that they will benefit less from growth than other households.

But contrary to widespread belief, growth does not necessarily lead to increased inequality. While some theoretical research suggests a causal relationship between growth and inequality (and *vice versa*), the consensus of the latest empirical research is that there is no consistent relationship between inequality and changes in income.

The experiences of developing countries in the 1980s and 1990s suggest that there is a roughly equal chance of growth being accompanied by increasing or decreasing inequality.⁷ In many developing countries, rates of inequality are similar to or lower than in developed countries. A series of studies using cross-country data all suggest that growth has neither a positive nor a negative effect on inequality.⁸

³ Lin (2003), *Economic Growth, Income Inequality, and Poverty Reduction in People's Republic of China*, Asian Development Review, vol. 20, no. 2, 2003, pp. 105-24

⁴ HBhanumurthy and HMitra (2004), *Economic Growth, Poverty, and Inequality in Indian States in the Pre-reform and Reform Periods*, Asian Development Review, vol. 21, no. 2, 2004, pp. 79-99

⁵ Arndt, James, and Simler (2006), *Has Economic Growth in Mozambique Been Pro-Poor?*, Food Consumption and Nutrition Division Discussion Paper 202

⁶ Ravallion (2007), *Inequality is Bad for the Poor*, Chapter 2 in *Inequality and Poverty Re-examined*, ed Jenkins and Micklewright, Oxford

⁷ Ravallion (2001) – *Growth, Inequality and Poverty Looking Beyond the Averages*

⁸ Chen and Ravallion (1997), Easterly (1999), Dollar and Kraay (2002), (Ravallion, 2004, 2007)

This is not to say that increased growth has not led to increasing inequality in some countries. Both China and India have seen widening inequality as their growth rates picked up over the 1990s. And both Bangladesh and Uganda would have seen higher rates of poverty reduction had growth not widened the distribution of income between 1992 and 2002. For example, one study suggests that the proportion of people living in poverty in Uganda at the end of this period would have been 30% instead of 38% had the poor benefited proportionally from growth.⁹

Due to the complex, two-way relationship between growth and inequality, it is impossible to say whether such proportional growth was possible. Even if it was, it may have come at the cost of higher growth. If the growth rate was curtailed sufficiently, the reduction in poverty may have been less than the high but relatively unequal growth experiences of each country.

Controlling for initial inequality of assets such as land and education, income inequality no longer seems to play a role in expanding or reducing the opportunities for growth.¹⁰ But asset inequality itself may be important because owning an asset that can be used as collateral can expand access to financial markets. Such access is likely to be growth-enhancing when it allows more households the opportunity to invest – which is especially important in economies where the average firm size is small.

Reducing asset inequality is a challenge, as it concerns the stock of wealth rather than the flow of income. Redistribution of assets may have an adverse effect on the incentives to save and invest, which may more than counteract the positive effects of more equitable asset ownership. Moreover, it is often politically contentious, and may be destabilising.

⁹ Besley and Cord (2007)

¹⁰ Birdsall, N. and J.L. Londono (1997), 'Asset Inequality Matters: An Assessment of the World Bank's Approach to Poverty Reduction', *American Economic Review*, 87(2), AEA Papers and Proceedings: 32-37.

Growth creates jobs

Economic growth generates job opportunities and hence stronger demand for labour, the main and often the sole asset of the poor. In turn, increasing employment has been crucial in delivering higher growth. Strong growth in the global economy over the past 10 years means that the majority of the world's working-age population is now in employment.

At the same time, in every region of the world and particularly in Africa, youth unemployment is a major issue. This is reflected in higher than average unemployment rates: young people make up 25 per cent of the working population worldwide but 47 per cent of the unemployed.

Nevertheless, since the early 1990s, global employment has risen by over 400 million. While China and India account for most of this increase, almost all of the new jobs have been created in developing countries.¹¹

Real wages for low-skilled jobs have increased with GDP growth worldwide, which indicates that the poorest workers have benefited from the increase in global trade and growth.¹² Fears that greater global integration and ever more 'footloose' international investors would push down wages have proved to be unfounded. Indeed, evidence on foreign direct investment suggests that firms are attracted to countries with higher, not lower, labour standards.¹³

Macroeconomic factors, such as low inflation, export orientation and low labour taxes, help to determine how much employment is created by growth. Structural factors, such as the balance of the economy between agriculture, manufacturing and services, are also important.

While the relationship between growth and employment remains robustly positive, the strength of the link has weakened slightly since the turn of the millennium. This has raised concerns about 'jobless growth' in some countries.

Between 1999 and 2003, for every one percentage point of additional GDP growth, total global employment grew by 0.30 percentage points – a drop from 0.38 for 1995-99.¹⁴ This may prove a problem for some countries in the Middle East, South Asia and sub-Saharan Africa, where the number of jobs being created may not be high enough to absorb their growing workforces.

But even if the relationship between growth and employment is weakening, this may suggest a stronger rationale for a higher growth strategy in the future. Furthermore, the trend may mask improvements in productivity that could provide the basis for the creation of even more job opportunities in the longer term.

¹¹ Global Economic Prospects, 2007

¹² Teal (2006), 'What Africa needs to do to spur growth and create well-paid jobs' CSAE

¹³ From Global Economic Prospects, 2007, box 4.5.

¹⁴ S. Kapsos, (2005), Employment Intensity of Growth: trends and macro-determinants, ILO,

What kinds of jobs?

The relationship between growth and employment is not simply about the quantity of jobs created by growth; it is also about the types of jobs created. In particular, there have been concerns that the number of jobs in the informal freelance sectors rises with growth alongside increases in the formal sector.

Traditionally, informal employment has been understood to be involuntary – a sector where ‘surplus’ workers scratch a living while ‘queuing’ for a limited number of better formal sector jobs. While informal employment is better than none at all, it has been assumed that it is very much second best to formal employment.

Recent evidence suggests that informal employment should not be seen as the disadvantaged counterpart of the formal sector but as a legitimate alternative, one that fosters entrepreneurial ambition.¹⁵ It is likely that a combination of these two views is applicable in most developing countries.

Certain countries and regions have relatively large informal sectors. For example, in Latin America, it was the primary generator of jobs in the 1990s with 60 per cent of new jobs created by micro-enterprises, own-account workers and domestic services. In Africa, if rural and agricultural sectors are included, the figure is closer to 90 per cent.¹⁶

The combination of excessively regulated labour markets and low levels of development is the principal driver of the informal sector. Careful deregulation of labour markets will reduce the cost of employment for firms in the formal sector and increase the share of formal employment. Of course, this may come at a cost to those already employed in the formal sector. There is thus a trade-off between the amount of formal employment and the benefits it provides, and individual countries will need to consider reform in this area carefully.

¹⁵ Note by informal we do not mean illegal employment see Maloney (2004), ‘*Informality Revisited*’, World Development.

¹⁶ See Maloney (2004), ‘*Informality Revisited*’, World Development

Growth drives human development

Economic growth is not just associated with reducing poverty. There is also clear evidence for a positive link between economic growth and broader measures of human development.

Economic growth is not fundamentally about materialism. Nobel laureate Amartya Sen has described economic growth as a crucial means for expanding the substantive freedoms that people value. These freedoms are strongly associated with improvements in general living standards, such as greater opportunities for people to become healthier, eat better and live longer.¹⁷

Growth generates virtuous circles of prosperity and opportunity (see Figure 2). Strong growth and employment opportunities improve incentives for families to invest in education by sending their children to school. This may lead to the emergence of a strong and growing group of entrepreneurs, which will generate pressure for improved governance. Strong economic growth therefore advances human development, which, in turn, promotes economic growth.

Equally, weak economic growth implies vicious circles in which poor human development contributes to economic decline, leading to further deterioration in human development. For many countries, achieving the Millennium Development Goals will require breaking out of vicious circles to enter virtuous circles.

The link between economic growth and human development operates through two channels. First, there is the 'macro' link whereby growth increases a country's tax base and therefore makes it possible for the government to spend more on the key public services of health and education.

Growth is essential if governments are going to be able to continue to provide public services, which directly benefit the poor. Although aid may provide initial support, increasing public expenditure in developing countries must ultimately be financed by collecting greater tax revenues. Given the generally low levels of tax revenue collection (often still below 20 per cent of GDP in African countries), this can only be achieved in the long-run by strong and sustained growth.

Botswana and Kenya provide contrasting examples of this macro link. In 1960, the two countries had similar levels of per capita income and spent approximately nine per cent of their GDP on health and education over the next three decades. But by 1990, because Botswana had grown by 6.5 per cent a year while Kenya had only grown by 1.6 per cent a year, Botswana was spending five times as much as Kenya on these sectors.¹⁸

A review of nine countries shows that higher growth during the 1990s was indeed accompanied by bigger increases in government budgets.¹⁹ A DFID study shows that

¹⁷ Sen, A (1999), *Development as Freedom*, Oxford University Press

¹⁸ UNDP (1996), *'Human Development Report 1996'*, United Nations Development Programme, New York

¹⁹ Wilhelm, V and I Fiestas (2005), *'Exploring the link between public spending and poverty reduction: lessons from the 1990s'*, World Bank Institute, Washington, DC

on average for low-income countries, a 10 per cent increase in per capita income is associated with an 11 per cent increase in education expenditure, an 11.4 per cent increase in health expenditure and a 12.7 per cent increase in tax revenue. A sustained two per cent increase in per capita growth would bring forward the date at which a typical low-income country could domestically finance recommended health expenditure rate (\$40 per capita) by 33 years.²⁰

The second channel between growth and human development is a 'micro' link, whereby growth raises the incomes of poor people and thereby increases their ability to pay for activities and goods that improve their health and education.

Vietnam's experience between 1993 and 1998 is an example of this. The country's high rate of growth during that period (six per cent a year) led to significant increases in household incomes (seven per cent a year). This resulted in increased demand for education: the average length of time that children attended school rose from 7.5 to 8.1 years, and enrolment rates in secondary schools increased by approximately eight percentage points.²¹

In general, a growing economy tends to provide greater job opportunities. These lead in turn to increased demand for education as people expect higher returns for them and their children from the investment of time and money in acquiring skills.²²

The link works equally in the opposite direction. Increased government spending on health and education tends to boost growth in the future, and households reap the benefits from increased investments in health and education through higher future incomes. This generates a virtuous circle of development.²³

Improved health and education through growth

There is overwhelming evidence that higher incomes lead to a better quality of life, not least in terms of the Millennium Development Goals on health and education. Key research findings here include the following:

- Higher levels of income reduce infant mortality.²⁴ India demonstrates the strength of this relationship: a 10 per cent increase in GDP is associated with a reduction in infant mortality of between five and seven per cent.²⁵
- Primary and secondary school enrolment rates are positively associated with higher levels of per capita income.²⁶

²⁰ Venables (2006) – Economic Growth and National Finance of Public Services

²¹ Glewwe, P and H G Jacoby (2004), 'Economic growth and the demand for education: is there a wealth effect?', *Journal of Development Economics*, Vol. 74, pp. 33-51

²² UNDP (1996), *'Human Development Report 1996'*, United Nations Development Programme, New York

²³ See HMT DFID (2005), *From commitment to action: human development and growth*, for a fuller discussion

²⁴ Pritchett and Summers (1995)

²⁵ Bhalotra (2006), *Childhood Mortality and Economic Growth*, WIDER research paper No. 2006/79

²⁶ HMT DFID (2005), *From commitment to action: Human development and growth*

- Educational outcomes such as test scores and the rates at which children repeat a year's schooling or drop out of school are significantly affected by per capita income.²⁷
- There is usually less disease in wealthier countries. For example, the prevalence of HIV/AIDS is 3.2 per cent for the least developed countries, 1.8 per cent for low-income countries, 0.7 per cent for middle-income countries and 0.3 per cent for high-income countries.²⁸
- Life expectancy is clearly positively related to the level of per capita income, according to cross-country evidence.²⁹
- In addition to beneficial effects on health and education, political, gender and ethnic oppression are typically lower the wealthier the country.³⁰

But while growth can have strongly positive effects, it is not sufficient for making more rapid advances in human development. For example, both Angola and Georgia have per capita incomes of \$2,200, but while Georgia's levels of health and education are almost as high as those in OECD countries, Angola's are among the worst in the world.³¹

In the 2002 Human Development Index (which measures countries' performance in terms of life expectancy, adult literacy, school enrolment and average income), Equatorial Guinea was ranked 103 places lower than on its growth performance – reflecting poor governance of its huge oil wealth. Other poor performers on human development relative to growth include Botswana (67 places lower), South Africa (66), Gabon (50), Namibia (48) and Angola (38).³²

The strong links between growth and human development are often mediated by policy choices and structural factors, such as the priority given to investing in health and education vis-à-vis other potential policy interventions to achieve faster growth.³³

²⁷ Ibid. Barro and Lee (1997)

²⁸ UNDP (2004), *'Human Development Report 2004'*, United Nations Development Programme

²⁹ Barro and Sala-i-Martin (1995) Cited in Easterly (1999), *Life During Growth*, *World Bank*.

³⁰ Boone (1996)

³¹ HMT DFID 2005

³² Commission for Africa, page 223

³³ HMT DFID 2005

2. THE CHALLENGE OF ACHIEVING STRONGER ECONOMIES

'Is there some action a government of India could take that would lead the Indian economy to grow like Indonesia's or Egypt's? If so, what exactly? If not, what is it about "the nature of India" that makes it so? The consequences for human welfare involved in questions like these are simply staggering. Once one starts to think about them, it is hard to think about anything else.'

Robert Lucas, Nobel laureate in economics, University of Chicago
The Mechanics of Economic Development (1985 Marshall Lectures)

During the 1990s, economic growth in the developing world outpaced that in the developed world for the first time. This led to a decline in aggregate poverty rates and the number of people living on less than \$1 a day. Nevertheless, progress has been uneven across countries and regions.

Economic growth in East Asia has averaged nine per cent a year over the last 15 years, largely driven by China. The number of people living on less than \$1 a day fell from 472 million in 1990 to 213 million in 2003, although inequality rose over the same period. The region's share of world income doubled in the quarter century to 2005, and its share of world exports tripled.

Over the same period, South Asia has had a lower average annual growth rate of 3.8 per cent. Per capita growth rates were dampened by persistent high population growth in some places, and often associated with rising inequality. And while both India and Pakistan have seen recent accelerations in their growth rates, growth remains fragile.

Sub-Saharan Africa will probably not meet the first Millennium Development Goal of halving the proportion of people living on less than \$1 a day. Between 1980 and 2000, growth averaged 2.2 per cent a year and per capita income stagnated. Africa's shares of world income and world trade halved.

However, Growth has picked up significantly in recent years, averaging five per cent a year, largely because of improvements in policy and increases in oil and metals prices.

The global growth record

In the aftermath of the Second World War, many developing countries sought to emulate the achievements of the developed world. Rapid industrialisation was viewed as the key to growth, and it was encouraged by a mixture of subsidies to industry, tariff protection and, in many cases state ownership.

But many of these favoured industries were not sustainable after the removal of their state protection. Consumers, taxpayers and workers suffered as inappropriate industries were kept as going concerns by government support. Developing countries typically had a surfeit of labour: capital-intensive industries were therefore inappropriate. The agricultural sector was often crippled under high taxation to pay for these schemes. And the environmental impact of attempting to develop heavy industry away from the scrutiny of established regulators was often disastrous.

The response to these failures was to limit the role of governments in the economy and, in the late 1980s and early 1990s, to try to focus on the 'right policies'. These were those policies associated with what John Williamson called the 'Washington consensus': lower fiscal deficits; lower taxes; lower import tariffs; fewer restrictions on international trade and capital flows; privatisation; deregulation; secure property rights; and a greater role for markets in allocating resources more generally.

As the 1990s unfolded, countries around the world implemented policies consistent with that consensus:

- In Africa, countries such as Ghana, Tanzania and Uganda embarked on privatisation, retrenched the public sector and liberalised trade.
- In Asia, India abandoned central planning, embracing a wide range of reforms, and China continued its market-oriented reforms.
- In Eastern Europe and the former Soviet Union, market reforms followed the end of communism.
- In Latin America, countries stabilised their economies, defeated hyperinflation, further opened their markets to international trade and capital, and privatised public enterprises.
- In places as diverse as Bolivia, Brazil, India and Russia, grossly overvalued exchange rates became more competitive.

In the early 1990s, most economists believed that these developments, combined with a favourable international environment, would enable developing countries to put the 'lost decade' of the 1980s behind them and return to a path of sustained growth. But the results were mixed with some countries benefiting more than others. For example:

- Sub-Saharan Africa failed to take off, despite some policy reform, improvements in the political and external environments, and continued foreign aid. The successes – Mozambique, Tanzania and Uganda – remain fragile more than a decade later.
- Severe financial crises disrupted markets and growth across a wide range of developing countries, including Mexico in 1994, East Asia in 1997, Russia in 1998, Brazil in both 1999 and 2002, Turkey in 2000 and Argentina in 2001.
- The Latin American recovery in the first half of the 1990s proved short-lived. The 1990s saw lower growth in per capita income in Latin America than between 1950 and 1980, despite the dismantling of the state-led, populist and protectionist policy regimes of the region.
- Transition economies in Eastern Europe saw an unexpectedly deep and prolonged collapse in output. Many took more than a decade to recover to the levels of income they had in 1990.

World Bank research³⁴ shows that out of 117 developing countries with populations of more than half a million, only 18 countries can be defined as having had a 'successful' growth experience in the 1990s. These are countries that narrowed the gap with the OECD countries over the 1990s, and sustained per capita growth of at least one per cent during the 1980s.

The 18 countries – Bangladesh, Bhutan, Botswana, Chile, China, Egypt, India, Indonesia, Laos, Lesotho, Malaysia, Mauritius, Nepal, South Korea, Sri Lanka, Thailand, Tunisia and Vietnam – account for about 60 per cent of the world's population and are extremely diverse economically, politically and historically.

What is common among these countries has been their persistent ability to grow over time. The challenge of development is therefore to transform growth episodes into sustained growth. Albeit with different degrees of success, the 18 countries have been able to meet this challenge.

³⁴ Pritchett (2005), Country Note B in World Bank (2005), Economic Growth in the 1990s: Learning from a Decade of Reform

Four lessons from research and experience

There are many lessons from this period most notably that those countries that have been successful implemented reforms in a manner that departed from conventional wisdom. Rapid economic growth in China, India and a few other Asian countries has resulted in an absolute reduction in the number of people living in extreme poverty.³⁵ China and India increased their reliance on market forces, but their policies differed in many respects from those advocated by the Washington consensus.

The World Bank's 2005 report is probably the most comprehensive attempt at making sense of the facts of the last decade and a half and synthesising much of the research evidence. The central result of this body of research is a rediscovery of the complexity of economic growth, recognising that it is not amenable to simple formulas:

'There is no unique universal set of rules. Sustained growth depends on key functions that need to be fulfilled over time: Accumulation of physical and human capital, efficiency in the allocation of resources, adoption of technology, and the sharing of the benefits of growth. Which of these functions is the most critical at any given point in time, and hence which policies will need to be introduced, which institutions will need to be created for these functions to be fulfilled, and in which sequence, varies depending on initial conditions and the legacy of history.'³⁶

Four overarching lessons from recent experience and the latest research are notable:

1. There is no one right answer

A mistake often made in the early 1990s was to translate general policy principles into a unique set of policy actions. In the words of the World Bank report:

'The principles of ... 'macroeconomic stability, domestic liberalisation, and openness' have been interpreted narrowly to mean 'minimise fiscal deficits, minimise inflation, minimise tariffs, maximise privatisation, maximise liberalisation of finance', with the assumption that the more of these changes the better, at all times and in all places – overlooking the fact that these expedients are just *some* of the ways in which these principles can be implemented.'³⁷

There are no best-practice policies that will always yield the same positive result. To sustain growth requires key criteria to be met, but there is no unique combination of policies and institutions for fulfilling them.

For example, creating stronger incentives for private investment may require improving the security of property rights in one country, but enhancing the financial sector in another. Technological catch-up may call for stronger or weaker patent protection, depending on the level of development.

³⁵ See Rodrik (2005) 'Growth Strategies,' in P. Aghion and S. Durlauf, eds., Handbook of Economic Development

³⁶ World Bank (2005) Economic Growth in the 1990s: Learning from a Decade of Reform'

³⁷ World Bank (2005), p. 11, emphasis in the original

This helps to explain why growing countries have such diverse policy configurations, and why attempts to copy successful policy reforms in another country often end up in failure.

II. Institutions matter

The institutional context is perhaps the single most important factor in determining whether a given policy will be appropriate or not. Institutions may be crudely seen as the framework in which markets operate: the basis of the rule of law and enforcement of property rights. Institutions are often deeply rooted and are difficult to change, though unlike some other contextual factors (such as climate and location), change is possible.

A wide variety of events and policies are influenced by different institutional settings. For example, natural resource endowments can be beneficial to countries with well-defined and enforceable property rights, such as the UK or Norway, but are often detrimental in countries without these rights, as in many African countries. This is because without well-defined property rights, there is a temptation for individuals to attempt to obtain the resources of others either illicitly (theft) or using the legal process (disputed ownership).

Incentives for investment in physical and human capital, the scope for technology transfer and a whole host of other key conditions for growth depend on the institutional setting.

III. Timing is everything

Too often, research has focused simply on *what* is needed. The question of *when* it is needed has seldom been investigated, which has led to disastrous outcomes. Two separate factors are crucial: the sequencing of policies; and the speed at which they are introduced.

In Eastern Europe, market-based reforms were introduced as 'shock therapy': quickly and simultaneously. Institutional reforms were left incomplete even as large parts of the state-run economy were privatised and deregulated. This contributed to the collapse in output in many of these countries in the early 1990s.

In Brazil in the early 1990s, trade reforms were introduced rapidly, without much concern for the competitiveness of the exchange rate and the response of the manufacturing sector.

In contrast, during the same period in India, trade reforms were introduced at a gradual pace, and so were designed to enable domestic firms to restructure and spread the costs of adjustment over time. The exchange rate was kept competitive to ensure export growth, and the Indian industrial sector flourished.

IV. Focus is crucial

Reform efforts need to be selective and focus on the 'binding constraints' on economic growth. Governments must avoid the temptation to implement only the uncontroversial

policies and instead focus attention where it is needed. This makes it vital to avoid the formulaic approach of the Washington consensus, to recognise the individual characteristics of a country and to undertake more rigorous economic analysis.

While there is no foolproof method of identifying the binding constraints, common sense and economic analysis can help. For example, when investment is constrained by poor property rights, improving financial intermediation will not help fuel growth. When investment is constrained by a high cost of capital, improving institutional quality will not catalyse growth.

The World Bank report argues that experimentation and learning about the nature of the binding constraints are an integral part of the reform process. It is not easy for governments to identify the binding constraints at a given point in time and stage of development, but proposals for 'growth diagnostics' look promising (see box).³⁸

³⁸ Hausman, Rodrik, and Velasco (2006)

Growth diagnostics

It is impossible for governments to fix everything at once. Long lists of reforms can have the effect of impeding action and leading to inappropriate sequencing of the reforms that are implemented.

Prioritisation is key to formulating a credible growth strategy. This requires analysis that identifies both the key constraints on growth, and the obstacles to removing these constraints, including political obstacles. So not only is it essential to have sound economic analysis; it also requires an appreciation of the political context within a country.

Growth diagnostics is the process of identifying binding constraints on growth.³⁹ The process is a dynamic one: one constraint successfully removed will lead to another one binding.

The approach has been used with some success in countries in Africa and Latin America. One of the more recent 'growth diagnostics' was conducted on Uganda.⁴⁰ It concluded that:

- A lack of investment in infrastructure was the key binding constraint on Ugandan growth.
- Electricity was the most urgent problem, with major investment needed in the towns outside of Kampala to stimulate job creation.
- Road infrastructure was similarly of concern: existing roads need to be better maintained, and key bottlenecks near Kampala need to be widened.
- Financial intermediation, or a lack of it, would prove to be a key future constraint should this physical infrastructure be addressed.
- Power and fuel were highly priced.
- Poor coordination was the driver of problems in the infrastructure network, as well as in skills training.

These conclusions are not atypical of the whole of sub-Saharan Africa: infrastructure is often the binding constraint. This may have a regional dimension – for example, Kenya's infrastructure is a constraint on Uganda's growth given the necessity of importing and exporting through Mombasa. But the list of constraints may still differ from country to country, and these differences are likely to be greater between countries in different regions.

As well as identifying the obstacles that constrain growth, it is essential to assess the feasibility of – and incentives for – removing them. This is partly a matter of financial resources (such as funds to finance infrastructure), but it also depends on technical capacity and political economy. Often existing constraints benefit vested interests within the economy and these interests challenge reform. Therefore, even if two countries have a common list of constraints to be dealt with, the optimal method to alleviate those constraints may still differ between countries.

This is an area of the 'growth diagnostics' methodology that needs to be further developed and improved. Analysis requires understanding of the political environment in which reforms are occurring, of the way in which reform and growth will affect different interest groups, and of the role of political leadership in facilitating change.

Analysis is only useful once its conclusions are adopted by governments and placed at the heart of credible growth strategies. There is a great deal of room for improvement by governments and donors alike in the development of such strategies. And strategies need strong institutions to make them real. Capacity-building takes time and is labour-intensive.

³⁹ Hausmann Rodrik, and Velasco (2006).

⁴⁰ Uganda CEM (2007)

Eight essential conditions for strong growth

Specific country analysis of the binding constraints on growth and the policy actions likely to overcome them is essential in forming a growth strategy. As the latest research from sub-Saharan Africa shows, ‘the diverse history, opportunities and current growth conditions in different African countries, and how these make any growth strategy, [are] first and foremost, a country-specific task.’⁴¹

While there is no ‘one right answer’ in terms of policy, there is wide agreement on the essential, if not sufficient, pillars likely to underpin a successful growth strategy in low-income countries. Although a diversity of conditions and history precludes even a broad strategy that fits all low-income countries, the latest research from regions such as sub-Saharan Africa show that it is possible to narrow the scope of the process of searching for the most binding constraints and deciding what to do about them. There are some areas that need to be addressed, even if the way of addressing them depends on individual circumstances.

Growth is ultimately about investment in capital and labour and improving the productivity of these factors of production through the processes of innovation and technological absorption. The most pertinent question for low-income regions, such as sub-Saharan Africa, is therefore how to boost the low levels of investment and productivity growth that are characteristic of underperforming countries.

Common binding constraints that may need to be addressed include:

I. Physical capital

Growth requires investment in physical capital – the plants, machinery, raw materials, etc. that are central to production – and investment at all scales requires financial capital. Every country that has achieved sustainable growth has managed a significant increase in the levels of both domestic and foreign investment as a percentage of GDP. Significant technology is usually embodied in capital goods such as plants and machinery that help to support a country’s move up the technological ladder.

Restricted or expensive access to finance is a brake on such investment, particularly for small and medium-sized enterprises and for the informal sector. A well-functioning financial sector enhances economic growth through ensuring that capital is not left idle, that it is directed to where it is most beneficial, and that risks are borne efficiently.

The quality of investment matters alongside the quantity. Poorly targeted subsidies have the capacity to hamper growth by redirecting capital away from where it is most productive.

II. Human capital

Investment in education and skills can be as important as investment in machinery and plants in delivering growth. Investment in this ‘human capital’ is especially appealing as it directly leads to improved human development as well as helping to drive growth.

⁴¹ Ndulu et al (2007), Challenges of African Growth, World Bank, pg 3

The costs of this investment are both direct (for example, the cost of school equipment and books) and indirect (the opportunity costs of the wages lost from remaining in education). Amelioration of these, together with raising the return on education (the wages for skilled workers) is likely to increase educational investment.

A wide range of labour skills are needed to catalyse and sustain economic growth, including education at all levels from primary schools through to universities, and including technical and vocational training as well as 'learning by doing'. Unfortunately, progress in overcoming shortages of skilled and trained manpower in the world's poorest countries has been disappointingly slow.

Although basic education is widely considered to be critical for reducing poverty, there is emerging evidence that secondary and higher education are more significant in raising long-term growth rates and income levels as they play a key role in the creation and application of new knowledge and technologies.⁴² This effect occurs primarily through people's improved capabilities to absorb technological advances.

III. The rule of law

The business environment needs to have safeguards that ensure that the returns of investment will be collected by investors. Political instability, corruption and crime can all threaten potential returns and make investment unattractive and thus damage the prospects for growth. The cost of crime and the cost of security as a percentage of sales are particularly high in low-income regions such as sub-Saharan Africa.

Recent surveys of the investment climate in low-income countries identify the costs of legal enforcement of contracts and compliance with regulation as having the biggest negative impact on business profitability. Strengthening the capacity of relevant public institutions for protecting property rights can often therefore be important. Equally, evidence from Africa suggests that particular attention should be given to the prevention of corruption.

As well as curtailing domestic investment, poor property rights are likely to divert foreign investment elsewhere. This may substantially reduce the scope for technology transfer that will increase productivity and ultimately growth.

IV. Competitive markets

Competition typically ensures that consumers are able to obtain more goods at lower prices than under a monopoly. Judicious use of regulation will help foster a competitive environment. It is important that this is applied by an independent body that is not susceptible to capture by any particular interest group. While certain industries (such as utilities) do not readily lend themselves to competition due to the vast cost savings they possess if they are large, this does not apply in most cases.

⁴² For example, see Barro and Lee (1993); Barro (1998); Hanushek and Kim (1995).

Governments need to ensure that they do not themselves reduce open and fair competition, either wittingly or unwittingly. This may happen as a result of pandering to entrenched vested interests, or it may come from institutional hurdles such as expensive and time-consuming procedures to regulate business.

It is vital to ensure that businesses are able to enter and exit markets with relative ease, and that there are opportunities for business innovation. It is by this route that firms and industries can increase their productivity, which in turn drives long-term growth.

V. Macroeconomic stability

Investors make decisions based on the rate of return they expect to receive and the riskiness of the investment project: the higher the risk, the higher the required rate of return. A stable macroeconomic environment is crucial to reducing the risks associated with investment. This applies as much to human capital as it does to physical capital: people are less likely to want to bear the costs of education when there is a greater risk that they will be unemployed on completion.

A stable macroeconomic environment includes monetary policy that delivers low and stable inflation, effective management of government tax and spending to deliver public services; and an exchange rate regime that is not excessively distorted or volatile.

VI. Infrastructure

Investors need good access to knowledge, to inputs of capital, labour and raw materials, and to markets. This requires transport infrastructure, as well as the provision of a regular supply of electricity and other utilities. In Africa, transport and energy make up the largest proportion of indirect costs for businesses, weighing heavily on the competitiveness of firms in most African countries.⁴³

In addition to transport infrastructure, communication infrastructure is crucial in disseminating information about prices and markets across a wide area. In this respect, the spread of mobile communications has been revolutionary. In recent years, limited banking services have even become available using mobile telephones in many parts of the developing world.

VII. Openness to trade and investment

No country has grown on a sustained basis in recent times without successfully integrating into global markets. There are two facets to this: integration into goods markets and integration into input markets, notably integration into financial capital.

Openness of a country's goods markets enables growth, facilitating technology transfer, increasing competition and benefiting consumers.⁴⁴ In the past, some countries have followed a policy of 'import substitution', deliberately shielding their industries from

⁴³ Ndulu (2007).

⁴⁴ For instance, see Alcalá and Ciccone (2004) or Frankel and Romer (1999)

international markets to allow them to develop. The success of such policies has been mixed: governments often protected industries that were not sustainable without protection. As protection has costs in terms of lost growth, such policies were harmful.

The relationship between open capital markets and growth is less clear. Capital market integration allows smoothing of living standards, risk-sharing among countries and technology transfer from the developed world.⁴⁵

The challenge in both of these areas is the way in which openness is achieved. Proper sequencing and pacing of reform is needed to smooth the adjustment for domestic producers. This is especially important for capital market integration. Hasty liberalisation of capital markets facilitated many financial crises over the past decade, which significantly curtailed growth.

VIII. Increased agricultural productivity

Low-income countries typically have large agricultural sectors. Productivity increases in agriculture often serve as the catalyst for growth, as well as having strong effects on reducing poverty due to the high numbers of people involved in these sectors. Adapting or developing technologies and improving agricultural markets for seed, fertiliser and agricultural outputs will help this process.

For many poor African countries, agriculture will be the centrepiece of their efforts to achieve growth, poverty reduction and food security for the foreseeable future. A key challenge is to make agriculture more worthwhile by raising its profitability through technological innovation. This will be critical if poor regions such as Africa are to embark on a successful 'green revolution' to raise agricultural productivity and release labour for more diversified, higher productivity activities such as manufacturing.

Policy achievements and shortfalls

How have developing countries performed in recent years against the eight essential conditions for strong growth? Most have been successful in providing greater macroeconomic stability. Inflation and public sector deficits are down, and growth has responded to this improved policy environment, although fiscal challenges remain on both tax and public expenditure. The only caveat to this is that international financial crises can have particularly pronounced effects in developing countries.

Success is much more mixed on the other seven conditions. This is reflected in country circumstances that constrain the private sector. Examples include:

- In Ghana, a study of manufacturing firms between 1987 and 2003 found that growth of large formal employers has stagnated, while informal micro-enterprises have proliferated, due in large part to credit constraints and labour market regulations.

⁴⁵ For example, Borensztein, DeGregorio, and Lee 1998; and Lumbila 2005.

- In India, there is a looming skills shortage. The quality of elementary education is often low, and the government is seeking to expand the proportion of youth who have vocational education from less than five per cent to around 20 per cent.
- In Sierra Leone, the cost of opening a current account in the financial sector is more than 50 per cent of annual income per capita.
- In Nigeria, 95 per cent of firms have their own generators due to an unreliable power network. The figure for China is 20 per cent.
- In Burundi, the average time necessary to comply with all import procedures is 124 days. The OECD average is 12 days.
- In Rwanda, just 18 per cent of farmers use fertilisers and three per cent use improved seed varieties.

Having improved the macroeconomic climate, the core challenge now is for countries to develop strategies that prioritise micro-level reforms, build institutions and enable investment. Policy-makers need to identify those actions that have the highest impact and which can be implemented and sustained.

3. NEW DFID SUPPORT FOR GROWTH

'But the global poverty emergency cannot be solved by one organisation or even a coalition of governments on their own: we now need the concerted efforts of private, public and third sectors working together - a new public-private alliance founded on promoting trade and growth.'

Gordon Brown, November 2007

Putting growth and opportunity at the heart of the development dialogue

DFID will work with countries that have a commitment to securing economic growth and a credible strategy for achieving this growth. Growth strategies should be based on rigorous and comprehensive analysis, and should be at the heart of the national development or poverty reduction strategy. Ownership by the country concerned is an important principle.

A growth strategy will involve a combination of economic policy initiatives and plans for expenditure on physical and social infrastructure and other growth-related activities. These initiatives should be fully costed and appraised, and decisions based on estimates of likely returns. They should be integrated in overall government decision taking, recognising trade-offs between expenditures in different sectors. They should also be integrated with macroeconomic projections and thereby give a view of future income levels, government revenue and expenditures, and external financing requirements both from donors and from capital markets.

The strategies will make clear the priorities for assistance and will be the basis of countries' relationships with donors, and for the formulation of DFID Country Assistance Plans and Joint Assistance Strategies.

Our objective is to put growth and opportunity at the heart of the development dialogue, particularly in Africa. This implies supporting countries poverty reduction strategies towards a new stage in their evolution. The focus of our partnerships will be on wealth creation and opportunity, with the private sector participating actively with governments and civil society to identify and address binding constraints to inclusive growth.

In Asia, the focus is more likely to be on ensuring that growth is more inclusive and opportunities exist for all. DFID should send a strong signal that countries' efforts to increase jobs and improve incomes are central to their development process and should stand ready to support their efforts.

Formulating and implementing growth strategies

DFID will make a stronger effort in assisting countries both in the formulation and delivery of their growth strategies. The strategies will be a key element underlying DFID Country Assistance Plans and Joint Assistance Strategies.

An economic growth strategy should be based on a rigorous economic analysis of country circumstances and opportunities. This involves assessment of the main constraints on growth and identification of market and government failures; analysis of the costs and benefits of actions that relax these constraints; and assessment of risks

to the proposed policy programme. The analysis will yield a prioritised sequence of actions (policy and institutional reforms and expenditures).

Formulation of such strategies involves high quality analytical work based on detailed knowledge of and research into the economy. This will involve government, the private sector, local researchers and support from external researchers. DFID proposes to establish a new **International Growth Centre** that will be able to provide support.

The centre could draw on high quality expertise from academia, the private sector and government. It could be envisaged as much as a network, as a physical presence. Established by international competition we will look to an academic base, or alternatively a business environment (or a mix of the two, such as a business school) to run the center. Country engagement might be enhanced by country level Growth Commissions made up of government, private sector and civil society, together with world leading academics and the international private sector.

The focus of work would be as much on future growth, looking at emerging opportunities and challenges from globalisation, and possibly at new environmental issues, as on the traditional agenda. Issues of exclusion would also be prioritised.

Key research issues include the importance of initial conditions in affecting the growth-poverty reduction nexus; whether growth in the 1990s led to sustained increases in inequality, or whether the relationship reflects specific initial conditions such as low levels of initial inequality or rapid structural transformation⁴⁶; and the factors that influence the relationship between economic growth and wider human development outcomes.

Working with other donors

Donor support for economic growth has been inadequate in recent years. DFID will mount an international influencing strategy to increase donor support for growth and to raise the quality and coherence of what is offered.

We will also renew our efforts to take a lead on developing international trade agreements that will allow low income countries to benefit from globalisation. The trade agenda is absolutely crucial to the challenge of involving all countries in the benefits of globalisation.

We should encourage development of more conducive South-South trade agreements, where there are great gains to be had. Trade is already greatly expanding between Africa, and China and India. We can help by both providing strategic technical assistance and also by encouraging the process at a political level.

We will encourage the development of international codes of practice, for example in respect of investment regimes, but also in a number of areas of economic management and regulation. The objective would be to extend best practice to areas such as investment regimes, natural resource revenue management, financial regulation, and competition policy.

⁴⁶ Besley and Cord (eds.) (2007), *Delivering on the Promise of Pro-Poor Growth: Insights and Lessons from Country Experiences*, World Bank

Working with the private sector

DFID should encourage the international private sector to play its part, working alongside the domestic private sector. Key proposals revolve around challenging business to leverage its core business and core skills and competencies to contribute to development. We envisage working with business in six sectors (retail, mobile phones, extractives, financial, infrastructure, and utilities) to develop action plans.

Promoting low-carbon growth

The issue of how to achieve environmentally sustainable, low carbon growth in developing countries is one that requires new impetus. This involves socio-economic and scientific research, and work with governments and the private sector to take research into practice.

International agreements for mitigation and carbon trade need to be refined and implemented. Strategies need to be developed to ensure that new technological innovations are adapted to and disseminated in developing countries. DFID has established a small team tasked with thinking through appropriate policies and instruments to take this agenda forward.

Our Commitment

In order to achieve the objective of more rapid economic growth, DFID will play a lead role in putting growth for sustainable poverty reduction at the heart of the international development dialogue. It will seek partner country commitment to credible growth strategies, support the formulation and implementation of such strategies, and work with other donors to improve the quality of support that is offered.