



Applied Knowledge Services
Governance · Social Development · Humanitarian · Conflict

Inclusive Growth

Topic Guide

About this Topic Guide

This guide summarises some of the most **rigorous** available evidence on the key debates and challenges surrounding inclusive growth. GSDRC Topic Guides aim to provide a clear, concise and objective report on findings from rigorous research on critical areas of development policy. Rather than provide policy guidance or recommendations, their purpose is to inform policymakers and practitioners of the key debates and evidence on the topic of focus, to support informed decision-making.

Author and contributors

This GSDRC Topic Guide was written by Kyle Alexander. Its production was **supported by the UK Government.**

GSDRC appreciates the contributions of Isabelle Cardinal (DFID), Simon Armstrong (independent consultant), Nicholas Miles (independent consultant) and Huma Haider (GSDRC).

About GSDRC

GSDRC is a partnership of research institutes, think-tanks and consultancy organisations with expertise in governance, social development, humanitarian and conflict issues. We provide applied knowledge services on demand and online. Our specialist research team supports a range of international development agencies, synthesising the latest evidence and expert thinking to inform policy and practice.

GSDRC

International Development Department, College of Social Sciences

University of Birmingham, B15 2TT, UK

www.gsdr.org

© DFID Crown Copyright 2015

This Topic Guide is licensed under the Open Government Licence:

www.nationalarchives.gov.uk/doc/open-government-licence

The views expressed in this report are those of the author, and do not necessarily reflect the opinions of GSDRC, its partner agencies or DFID.

Suggested citation

Alexander, K. (2015). *Inclusive growth: Topic guide*. Birmingham, UK: GSDRC, University of Birmingham.

UNIVERSITY OF
BIRMINGHAM

Supported by:



Contents

1	Executive summary	1
2	Concepts and definitions	3
3	Growth, poverty and inequality	7
4	The ingredients of inclusive growth	13
4.1	Productive jobs and labour	14
4.2	Economic transformation	16
4.3	Infrastructure	18
4.4	Human development	19
4.5	Fiscal policy	20
4.6	Social protection	21
4.7	Institutions	22
5	The politics of inclusive growth	23
6	Measuring inclusive growth	26

1 Executive summary

1.1 Concepts and definitions

Absolute poverty has fallen substantially over the last 30 years, with most of this reduction attributable to rapid economic growth in developing countries. However, the recognition that economic growth often does not meet the needs of the poor has stimulated the current debate on the need for inclusive growth. Economic growth in the absence of measures to ensure the sustained equitable distribution of the benefits of growth has frequently perpetuated the concentration of wealth in the hands of those already better off. As a consequence, many governments and donors have come to realise that in order to significantly reduce poverty they must promote inclusive growth.

Despite the increased and urgent attention paid to the promotion of inclusive growth, there is no unanimous definition of the concept. A commonly used definition is that employed by the World Bank (2009), which defines inclusive growth as an absolute reduction in poverty associated with the creation of productive employment rather than direct income redistribution schemes. The World Bank maintains that inclusive growth should take into account both ‘the pace and pattern of growth’; these are considered to be linked and should therefore be addressed together.

1.2 Growth, poverty and inequality

Promoting **inclusive** growth **requires** policymakers to **address** both growth and **income** distribution, so it requires an understanding of the relationships between growth, poverty and inequality. Many studies have demonstrated that economic growth is a prerequisite for poverty reduction when income distribution is held constant. There is also consensus that the two primary factors which determine why there are different rates of poverty reduction at a given rate of growth are the initial level of inequality and how inequality changes over time.

In light of this ‘essentially arithmetic’ relationship, Bourguignon (2004) emphasises that understanding the two-way relationship between growth and inequality is the real challenge for producing a development strategy focused on fostering pro-poor or inclusive growth.

Several mechanisms that cause growth to change the distribution of income in an economy have been proposed. Some authors posit that growth alters the distribution of resources and labour in an economy as it grows, which in turn affects the distribution of income. Others cite institutional change, and propose that as average incomes grow there is a greater demand for adequate public services and accountable institutions, which in turn reduces inequality.

Empirically, cross-country **regressions indicate** that there is no clearly discernible relationship between growth and **inequality** (the **incomes of the poor** tend to rise in line with an increase in average incomes). However, country-specific case studies find a strong and complex relationship between growth and inequality, which can be obscured by cross-country studies. Practitioners should note this when designing country-specific policies and interventions to promote inclusive growth.

In the other direction, credit market imperfections, redistributive pressures and unaccountable institutions are posited as mechanisms through which inequality hampers growth. Empirically, there is similarly no overall relationship found between initial inequality and average growth rates. However, there is some consensus that marked high inequality reduces the rate at which the income of the poor increases in relation to that of the rich, and some emerging evidence that more equal distribution of income is associated with longer periods of growth.

1.3 The ingredients of inclusive growth

The acknowledgment that inequality affects the impact of growth on poverty reduction has led to a broad agreement that it is necessary to look beyond a 'growth-first' agenda in order to successfully deliver inclusive growth.

A robust inclusive growth strategy will complement policies to stimulate economic growth with those that foster equality of opportunity, alongside a social security net to protect the most vulnerable. As such, economic policies to promote structural transformation and create productive employment for poor people will need to be complemented by investments in human capital and other programmes to support social inclusion and equal access to jobs.

Consensus also prevails concerning the need for social protection measures targeted at the most vulnerable groups in society. Finally, it is often emphasised in the relevant literature that governments must widen their tax base in order to sustainably fund spending on inclusive growth.

1.4 The politics of inclusive growth

It is recognised that implementing economic and social policies to promote inclusive growth will not take place in a vacuum, but will require political institutions and arrangements to sustain them. Many academics, donors and policymakers have argued from a conceptual standpoint that inclusive growth will require inclusive institutions that enable all citizens to hold their governments accountable.

Empirically, there is little evidence to show that inclusive institutions are a prerequisite for inclusive growth. More significant is the ability of the state to enact policies that are growth enhancing and promote increases in productive employment. Practitioners should note the experience of China, which has significantly reduced absolute poverty without establishing what can be formally described as inclusive institutions (OECD, 2014).

Similarly, while some authors find that there is a two-way causal relationship between institutional quality and inclusive growth, it is less clear which types of institutional improvements result in sustained and inclusive growth. This is in line with Khan's (2012) argument that all-encompassing good governance reforms are difficult to implement in developing countries due to the nature of their political settlements, and that care needs to be taken to identify the specific institutional solutions that can be implemented under specific political settlements.

1.5 Measuring inclusive growth

A shortage of robust data and the current lack of a universally accepted definition of inclusive growth will make successful measurement of inclusive growth programmes and policies challenging. Nevertheless there is some agreement in the literature on the methods required to measure and analyse inclusive growth policies, and how this should differ from the measurement of pro-poor growth.

Measuring inclusive growth will involve *ex ante* analyses that examine ways of increasing the pace of growth by involving underused sections of the labour force. This differs from the measurement of pro-poor growth, which has typically focused on the *ex post* tracking of poverty measures to observe the impact of growth on poverty reduction. Indices used to track inclusive growth at a country level should also use indicators that measure the economic participation of poor people in the growth process, as well as those that gauge the improvement in economic outcomes for the poor as a result of growth. In contrast, measurements of pro-poor growth policies often focus solely on outcomes.

2 Concepts and definitions

There is broad agreement amongst academics, donors and practitioners that the substantial decline in absolute poverty over the last three decades has been due to rapid economic growth (Dollar, Kleineberg and Kraay, 2013; Commission on Growth and Development, 2008). However, the current emphasis on inclusive growth stems from a recognition that prioritising economic growth alone cannot meet the development needs of poor people, as it fails to directly address issues such as inequality and unemployment. Rather than a focus on rapid growth alone, inclusive growth ‘refers both to the pace and pattern of growth’ (World Bank, 2009), which are considered to be linked and should therefore be addressed together.

The concept of inclusive growth is based on the recognition that economic growth must be increasingly ‘pro-poor’. The concept represents recent thinking on development, and supplants the ideas of ‘trickle-down development’ advocated in the 1950s and 1960s (Kakwani and Pernia, 2000), and the policies associated with the Washington Consensus of the 1980s and 1990s. To define inclusive growth, it is crucial to understand the literature on pro-poor growth – primarily because the definitions of these terms overlap. The literature on pro-poor growth represented the first significant departure from the belief that poverty reduction requires economic growth to be prioritised above all else.

Box 2.1: Other growth concepts

‘Broad-based growth’ and ‘shared growth’ are other terms commonly used in policy discussions on poverty reduction in a development context, often with no clear distinction from inclusive growth or pro-poor growth.

Shared growth: While it has been used synonymously with inclusive growth, the term shared growth can mistakenly imply a focus on income distribution schemes. The World Bank (2009) has therefore indicated a preference for the term inclusive growth.

Broad-based growth: The term broad-based growth first came into usage in the *World Development Report 1990* (World Bank, 1990), indicating growth that involved a range of sectors across a country’s economy. It is now arguably subsumed within the World Bank’s definition of inclusive growth as ‘broad-based across sectors, and inclusive of the large part of the country’s labour force’ (World Bank, 2009).

From pro-poor growth...

There are two key definitions of pro-poor growth:

- The **absolute** definition, which states that economic growth can **only** be pro-poor **if** the average **incomes** of poor people rise and as a consequence income poverty falls (Ravallion and Chen, 2003).
- The **relative** definition, which describes economic growth as being pro-poor **only if** the **incomes** of poor people increase at a rate which is greater than that of the non-poor – i.e. if poverty falls more than it would if all incomes increased at an equal rate (Kakwani and Son, 2003). The relative definition is concerned with changes in inequality that favour poor people.

DFID (2004) emphasises that the suitability of these two definitions depends on the objectives of the donor or practitioner, and notes that the absolute definition of pro-poor growth is more suitable for practitioners focused on poverty reduction. This is because under the relative definition, a change in inequality can be pro-poor without producing absolute benefits for poor people (this can occur in a contracting economy), while economic growth accompanied by an increase in inequality can still result in large absolute income gains for the poor (Ravallion, 2004; DFID, 2004).

...to inclusive growth

Despite the substantial literature and policy discussion on the topic, there is no unanimous definition of inclusive growth. For some authors, there is no obvious distinction between inclusive growth and pro-poor growth (Raniere and Ramos, 2013). Nonetheless, the World Bank has outlined a clear definition of inclusive growth, stating that it corresponds to the absolute definition of pro-poor growth apart from the following two distinctions:

- 'While absolute pro-poor growth can be the result of direct income redistribution schemes, for growth to be inclusive, productivity must be improved and new employment opportunities created' (Ianchovichina and Lundstrom, 2009; World Bank, 2009: 3).
- 'The pro-poor growth concept has traditionally focused on growth and poverty measures whereas inclusive growth focuses on an ex-ante analysis of the sources of, and constraints to sustained, high growth and poverty reduction' (World Bank, 2009).

The notion of productive employment highlighted in the first point has become central to the concept of inclusive growth, as it focuses not only on **outcomes** for poor people, but also on ensuring their participation in the **growth process**. As such, inclusive growth is related to the notion of broad-based growth across various sectors of an economy (see box below), but also requires non-discriminatory participation by large segments of the population for its *inclusiveness* to be realised (Klasen, 2010).

Box 2.2: Shared prosperity

The term 'shared prosperity' has recently surfaced in the international development arena as one half of the World Bank's new twin goals announced in 2013. Promoting shared **prosperity** can be defined formally as increasing 'the growth rate of **incomes** in the bottom 40 percent of households' (Dollar, Kleineberg and Kraay, 2013), and is viewed as a means of making economic growth more inclusive.

The Bank's rationale for using a measure of prosperity rather than inequality is twofold. Firstly, a society can become more equal without any improvement in the lives of the bottom 40 percent. Secondly, throughout history many countries characterised by strong economic growth have experienced short-term increases in inequality (see Box 3.1). Therefore, prioritising inequality could lead to policies that may limit the level of economic growth needed to improve the lives of the bottom 40 percent (World Bank, 2013).

Despite this justification, the World Bank's decision to focus on shared prosperity rather than a measure of inequality has generated substantial criticism. Policy specialists from Save the Children, Oxfam, and the Centre for Global Development (Guardian, 21 March 2013; Third World Economics, 2013) emphasise that poverty reduction will require tackling inequality, which in turn necessitates a measure that assesses the income gaps between the top and bottom of society, rather than just the bottom 40 percent. Others have also argued that focusing on shared prosperity as a development measure will lead to the promotion of policies that promote economic growth on the assumption that it will deliver poverty reduction (Woodward of NEF in Guardian interview, 2013). This they regard as a retrograde step reminiscent of a world of 'trickle-down' development.

There is not full agreement that building on the absolute definition of pro-poor growth is the best approach to defining inclusive growth. Klasen (2010) argues that when considering outcomes, 'inclusive growth should not focus solely on (income) poverty reduction because interpreting it in terms of disadvantage-reducing growth is potentially more interesting.'

Furthermore, other academics and policymakers have highlighted that despite the twin focus on process and outcomes, the definition of inclusive growth outlined above is still too narrow, as expanding human capabilities (e.g. through productive employment) are only regarded as instrumental in improving economic outcomes. Instead, a broader interpretation of inclusive growth may be required, in which non-income measures of human capabilities and well-being are valued as human development outcomes, rather than solely as instruments to accelerate economic growth (McKinley, 2010).

Annotated bibliography

World Bank. (2009). *What is Inclusive Growth?* Washington DC: World Bank

<http://siteresources.worldbank.org/INTDEBTDEPT/Resources/468980-1218567884549/WhatIsInclusiveGrowth20081230.pdf>

This summary note addresses the definitions of inclusive growth and analyses some of the literature which has contributed to the concept. It notes that rapid and sustained poverty reduction requires inclusive growth – rapid growth that is sustainable in the long-run, broad-based across sectors and inclusive of a large section of a country's labour force. Inclusive growth therefore encompasses both the pace and the pattern of growth, which are linked and must be addressed together. The authors highlight that inclusive growth focuses on improving the income of excluded groups by increasing productive employment rather than direct income transfers. This emphasis on productive employment, as well as a focus on *ex ante* sources of, and constraints on, sustained high growth and poverty reduction is what differentiates the inclusive growth concept from pro-poor growth. Central to increasing productive employment is employment growth, which generates new jobs and income for individuals, but also productivity growth, which has the potential to increase wages and profits.

Raniere, R. and Ramos, R. (2013). *Inclusive Growth: Building up a Concept*. Brasilia: International Policy Centre for Inclusive Growth

<http://www.ipc-undp.org/pub/IPCWorkingPaper104.pdf>

How has the concept of inclusive growth developed over time? This paper charts the shift in development thinking from the post-WW2 view that rapid growth and industrialisation was the most effective way to improve poor people's living standards by means of 'trickle-down' development, through to the debate around inclusive growth today. It is noted that despite the substantial literature on inclusive growth, no unanimous definition has emerged. Often there is no clear distinction between inclusive growth and pro-poor growth. Some definitions of inclusive growth differ from pro-poor growth in that they incorporate non-income dimensions while still focusing on outcomes, while others focus on who actually participates in the process of growth, often emphasising a concern for the increase of employment opportunities across all societal groups rather than among the poor alone. The notion of productive employment, which focuses on both outcomes and process, has been gaining traction in the inclusive growth debate. The authors conclude that specifying what 'inclusiveness' means, and establishing a framework to account for the relationships among the elements of inclusive growth, will be critical to defining, operationalising and measuring the concept.

Ravallion, M. (2004). *Pro-Poor Growth: A Primer*. Washington DC: World Bank

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3242>

This paper finds that there are two significantly different definitions of pro-poor growth in the literature. The relative definition holds when growth is accompanied by distributional shifts that favour the poor, while the absolute definition states that growth is pro-poor only when poor people benefit in absolute terms against an accepted poverty measure. A common empirical finding is that, at the country level, growth tends to be distribution neutral on average – i.e. inequality falls just as often as it rises after a period of economic growth. However, the paper notes that there may be significant measurement issues associated with these findings, and that no change in overall inequality can obscure the fact that there are significant winners and losers at all levels. Regardless of these caveats, it can be said that economic growth is typically pro-poor growth by the absolute definition. The author argues that, to devise a package of reforms that promotes growth and ensures the poor can participate in the growth process, it will be important to identify the country-specific and sub-national factors that influence the distribution of growth, and the extent to which those factors can be influenced by policy.

World Bank. (2013). *The World Bank Goals: End Extreme Poverty and Promote Shared Prosperity*. Washington DC: World Bank

<http://www.worldbank.org/content/dam/Worldbank/document/WB-goals2013.pdf>

In this paper the World Bank sets out its twin goals of ending extreme poverty across the globe within a generation and promoting shared prosperity. The poverty reduction target is a reduction in the number of people globally living with less than \$1.25 a day to under three percent by 2030. Promoting shared prosperity is defined as fostering income growth for the bottom 40 percent of the population of every country. It is therefore a focus on improving the income of the less well-off everywhere, not just in the poorest countries. The World Bank is unequivocal that economic growth is still central to the notion of shared prosperity, which will require 'expanding the size of the pie continuously' while sharing it in a way that ensures that the welfare of the bottom 40 percent increases as quickly as possible. The paper also analyses the relationship between inequality and shared prosperity. It highlights that income growth for the bottom 40 percent sometimes comes at the expense of a temporary rise in inequality (as in East Asia a few decades ago), and that a fall in overall inequality in a country can occur with almost no increase in incomes for the bottom 40 percent (as in Egypt from 2000-2010). Finally, while shared prosperity is fundamentally an income measure, the paper emphasises that promoting shared prosperity is also about progress in non-income dimensions of welfare.

Additional resources

DFID. (2004). *What is pro-poor growth and why do we need to know?* London: Department for International Development

<http://www.sed.manchester.ac.uk/research/iarc/ediais/pdf/BriefingNote1.pdf>

Provost, C. (2013, 21 March). World Bank's new vision on tackling poverty 'very unambitious'. *The Guardian*. <http://www.theguardian.com/global-development/2013/mar/21/world-bank-vision-poverty-unambitious>

3 Growth, poverty and inequality

There is a wealth of academic, donor and practitioner literature on the relationships between growth, poverty and inequality, some of which – particularly the two-way relationship between growth and inequality – are highly contested. Knowledge of these relationships is important for practitioners seeking to develop informed policies to foster inclusive growth.

Many studies have demonstrated that economic growth is a prerequisite for poverty reduction if income distribution is held constant (Deininger and Squire, 1997; Dollar and Kraay, 2001; Ravallion, 2002; Bourguignon, 2004). Similarly, there is consensus that the two factors that determine why there are different rates of poverty reduction at a given rate of growth are the initial level of inequality in a country, and how inequality changes over time. The higher the level of initial inequality within a country, the less poor people will gain from economic growth (Bourguignon, 2004; Ravallion, 2004; Balakrishnan, Steinberg, and Syed, 2013).

In light of this, Bourguignon (2004) notes that the relationships between growth and poverty, and inequality and poverty, are ‘essentially arithmetic’. He therefore emphasises that understanding the two-way relationship between growth and inequality is the real challenge for producing a development strategy focused on fostering pro-poor or inclusive growth.

The impact of growth on inequality

Numerous mechanisms which cause economic growth to alter the distribution of income within an economy have been proposed. A key strand in this literature is the theory that economic growth alters the distribution of resources and labour in an economy, which in turn affects the distribution of income. The Kuznets Curve hypothesis (see Box 3.1 below) is grounded in this viewpoint.

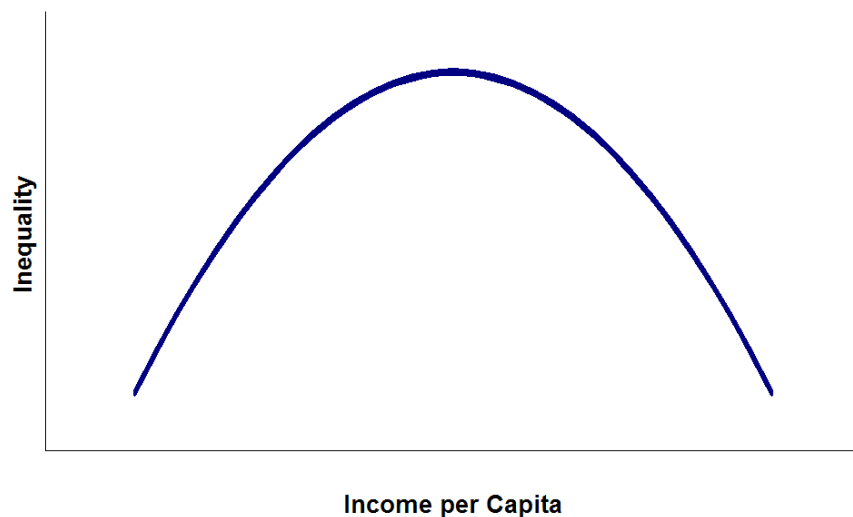
Institutional change is another key mechanism which may cause economic growth to change the distribution of income in an economy. As average incomes grow there is a greater demand for adequate public services and accountable institutions (Birdsall, 2007), and the transaction costs that constrain institutional change may become more affordable as a consequence of economic growth.

The empirical evidence for the impact of economic growth on inequality is mixed. Many authors have found clear evidence for the presence of the Kuznets Curve, implying that economic growth leads to an initial increase in inequality followed by a subsequent decrease. However, once detailed panels of household data enabled studies to assess changes of distribution of incomes over time within countries, cross-country regressions have revealed a strong one-to-one relationship between the growth of average incomes of the poor, and overall average incomes (Deininger and Squire, 1996; Dollar and Kraay, 2001; Dollar, Kleineberg and Kraay, 2013).

Some of the literature cautions, however, that cross-country regressions should not be relied upon to make meaningful generalisations, as the way in which economic growth affects income distribution is country specific (Kakwani and Pernia, 2000; Bourguignon, 2004). Instead, Bourguignon (2004) argues that country-specific case studies demonstrate a strong and complex relationship between growth and inequality which varies on a country-by-country basis, and that these types of studies will be important in enabling policymakers to develop successful country-specific policies targeting both growth and income distribution.

Box 3.1: The Kuznets Curve

The hypothesis that inequality first rises and then falls (in an inverted U-curve) as economic growth increases and an economy becomes more developed was first put forward by Kuznets (1955). The proposed cause of the initial increase in inequality was the shift of workers and resources from agriculture to industry during the early period of development, creating a significant urban-rural gap. Inequality will only begin to fall later in the development process, once 'trickle-down development' leads to workers earning higher wages and a welfare system being established.



Empirically, the presence of a Kuznets Curve is heavily contested. Many studies (Ahluwalia, 1976; Papanek and Kyn, 1986; Barro, 1999) find evidence that supports the Kuznets Curve hypothesis as an empirical regularity, but often find that the curve fails to explain the variations in inequality between countries or over time. Others criticise the hypothesis on the grounds that the inverted U-shape is a consequence of historical differences in inequality between countries, rather than the development of individual countries themselves. Deininger and Squire (1996) control for this historical difference in inequality in their analysis, and find no empirical evidence for the Kuznets curve.

The impact of inequality on growth

The literature on the impact of inequality on economic growth is likewise vast. Credit market imperfections, or an inability of the poor to borrow due to lack of collateral or underdeveloped capital markets, have been put forward by numerous authors as a hindrance to economic growth (Barro, 1999; Bourguignon, 2004; Birdsall, 2007).

Others cite redistributive pressures, either in a democratic context or through socio-political unrest, as channels through which inequality can constrain subsequent growth (Rodrik, 1998; Barro, 1999; Bourguignon; 2004). From an institutional perspective, Birdsall (2007) argues that high levels of inequality can discourage the development of institutions which make a market environment conducive to economic growth (e.g. an accountable government).

Empirically, the many authors find no clear relationship between overall inequality and subsequent economic growth. However, there is some consensus that inequality can negatively impact the growth of

poor people's incomes and positively impact the income growth of the rich (Barro, 1999; Birdsall, 2007; van der Weide and Milanovic, 2014).

Most of the literature regarding the impact on inequality of economic growth focuses on income inequality and long-run average growth. However, some studies have found that it is inequality of wealth rather than income that is an impediment to rapid growth (Deininger and Squire, 1997).

Other authors have argued that it is the impact of inequality on sustained periods of growth, rather than on the initiation of rapid growth, that should be assessed. By assessing breaks in growth, they find a robust association between lower inequality and sustained growth (Berg and Ostry, 2011; Berg, Ostry and Tsangarides, 2014).

Annotated bibliography

Bourguignon, F. (2004). *The Poverty-Growth-Inequality Triangle*. Washington DC: World Bank

http://siteresources.worldbank.org/INTPGI/Resources/342674-1206111890151/15185_ICRIER_paper-final.pdf

Should development policy focus on growth, poverty, or inequality? This paper argues that the quick elimination of all forms of absolute poverty is a meaningful goal for development. To achieve this, strong, country-specific combinations of growth and distribution policies will be required. As the relationships between growth and poverty, and inequality and poverty, are essentially arithmetic, the fundamental challenge for designing these policies lies in understanding whether growth rates and changes in income distribution are independent of each other or interrelated. Despite finding that country specificity undermines generalisations, the author states that redistributionary policies undertaken alongside the development process can help to mitigate the potential for growth to initially increase inequality (as per the Kuznets hypothesis). The paper then proposes several hypotheses (e.g. credit market imperfections and social conflict) for why lower inequality can lead to higher growth rates, but finds that cross-country regressions have been unable to prove these relationships.

Balakrishnan, R. Steinberg, C. and Syed, M. (2013). *The Elusive Quest for Inclusive Growth: Growth, Poverty, and Inequality in Asia?* Washington DC: IMF

<http://www.imf.org/external/pubs/ft/wp/2013/wp13152.pdf>

What impact has economic growth in Asia over the past two decades had on poverty reduction? This paper finds that while poverty has fallen across the region over the last two decades, increased inequality has reduced the impact of growth on poverty reduction. Asia's recent period of growth has been both less inclusive and less pro-poor in relation to other developing regions and compared to Asia's own past. Furthermore, past increases in inequality in Asia are likely to reduce the future impact of income growth on poverty, even if the level of inequality remains constant in the future. The paper then challenges the assertion made by Dollar and Kraay (and others) that incomes of the bottom quintile rise in line with average income during growth, and finds that once instruments are used for the income variable then the regression results point to the income of the bottom quintile rising less fast than average income. The paper also finds that increased spending on education, labour market reform, and financial inclusiveness are key factors in determining how inclusive or pro-poor growth has been in Asia.

Barro, R. (1999). *Inequality and Growth in a Panel of Countries*. Cambridge, Massachusetts: Harvard University

http://scholar.harvard.edu/files/barro/files/inequality_growth_1999.pdf

This paper begins with a theoretical explanation of four mechanisms by which inequality can affect growth and investment: credit market imperfections, redistribution under a democratic system, socio-political unrest, and savings rates. After conducting a regression analysis using a broad panel of countries, little overall relationship between income inequality and rates of growth and investment is found. The analysis shows, however, that higher inequality tends to slow down growth in poor countries, and

increase growth in rich countries (the threshold used \$2000 US in 1985 dollars). This finding may justify the use of redistributory policies in poor countries as a means of stimulating economic growth.

Dollar, D. and Kraay, A. (2001). *Growth is Good for the Poor*. Washington DC: World Bank

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-2587>

This paper tests the relationship between the growth of incomes of the poor (defined as the bottom 20 percent) and average income growth. After performing a cross-country regression analysis of 92 countries over four decades, Dollar and Kraay find a one-to-one relationship between growth of income of the poor and growth of mean income. The paper also finds that determinants of growth such as trade openness, financial development, strong property rights and rule of law have benefitted the poor as much as the average household, contrary to the arguments of many critics of globalisation. Similarly a number of 'pro-poor' policies, such as public expenditure on health and education and formal democratic institutions, are found to benefit the poor as much as the average household. Dollar and Kraay do not conclude from these findings that growth is all that is needed to improve the lives of the poor, but rather that growth enhancing policies such as trade openness and rule of law should be at the heart of any poverty reduction strategy.

Dollar, D., Kleineberg, T. and Kraay, A. (2013). *Growth Still is Good for the Poor*. Washington DC: World Bank

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6568>

This paper finds a very strong equiproportionate relationship between the average incomes of the bottom 40 percent and overall average incomes, leading the authors to conclude that 'growth still is good for the poor'. It is also established that there is no global trend towards greater inequality, as the income shares of the bottom 20 and 40 percent show no systematic tendency to decline over time. Finally none of the factors thought to matter for growth (e.g. financial openness and macro-stability) and inequality (e.g. primary school enrolments) are found to robustly correlate with an increased income share for the bottom 40 percent. The authors highlight the difficulty in using cross-national data to identify specific macro policy reforms to boost shared prosperity, as well as the fact that despite zero change in inequality on average there have been significant changes in inequality in certain countries during specific periods. Nonetheless, they conclude that economic growth will lead to shared prosperity on average, and that institutions and policies that promote economic growth in general will promote shared prosperity.

Deininger, K. and Squire, L. (1997). *Economic Growth and Income Inequality: Reexamining the Links*. Finance and Development: March 1997

<http://www.imf.org/external/pubs/ft/fandd/1997/03/pdf/deininge.pdf>

This article finds that the relationship between initial inequality and subsequent growth differs depending on whether initial inequality is measured in terms of income or land, with an uneven distribution of assets found to be more of an impediment to growth than income inequality. The authors argue that lack of access to credit is the key mechanism by which asset inequality results in poor growth. The authors also highlight that the aggregate measures of distribution often used can hide considerable changes in the incomes of different groups. They recommend that welfare analyses of the bottom quintiles should accompany any assessments of aggregate shifts in income. New data is then used to test existing hypotheses regarding growth and inequality. No evidence is found to back up the Kuznets hypothesis (see Box 3.1 above), while initial inequality of assets rather than income is found to have a strong negative impact on subsequent economic growth. Despite the strong relationship found between asset inequality and future economic growth, the impact of investment on growth and poverty reduction is found to be even stronger. The authors conclude that policymakers should not pursue a redistributive strategy at the expense of investment, as this could result in lower incomes for the poor.

Birdsall, N. (2007). *Income Distribution: Effects on Growth and Development*. Washington DC: Centre for Global Development

http://www.cgdev.org/files/13505_file_Income_Distribution_Birdsall.pdf

How does inequality impact subsequent economic growth? This paper finds that inequality is more likely to constrain economic growth in countries at low levels of income, defined as below about \$3200 per capita in 2000 dollars. It is at high levels of inequality (at or above a Gini coefficient of .45) that a negative association emerges between growth and inequality. Birdsall then defines three potential mechanisms through which inequality can negatively impact economic growth. Firstly, inequality can exacerbate the effect of incomplete and underdeveloped markets for capital and information, as creditworthy borrowers with no collateral are denied loans and their lack of wealth or income then stops them from making any investments at all. Secondly, high inequality can discourage the evolution of the economic and political institutions associated with accountable government, as the rich resist tax to fund public services which they can purchase privately. Thirdly, inequality may undermine the civic and social life that sustains effective collective decision-making, leading to impaired economic growth. For example, high inequality has been found to have a significant and positive effect on homicide rates in a cross section of 39 countries.

Ravallion, M. (2005). *Inequality is Bad for the Poor*. Washington DC: World Bank

http://siteresources.worldbank.org/INTWDRS/Resources/477365-1327693659766/8397901-1327773323392/Inequality_is_Bad_for_the_Poor.pdf

This paper identifies two factors as the main proximate causes of the differing impact of growth on poverty: the initial level of inequality and how inequality changes over time. The author then notes that despite the fact that numerous studies have found no aggregate trade-off between mean income and inequality, this does not mean that there are no trade-offs at the level of specific policies. Reducing inequality by adding further distortions to an economy may well have ambiguous effects on growth and poverty reduction. However, there is potential for 'win-win' policies, as some of the factors that impede growth also stop the poor from accessing the opportunities unleashed by growth. Successful policies can focus on either correcting the underlying market and governmental failure or on directly intervening to redress the asset inequalities, by fostering poor people's accumulation of physical and human assets.

Berg, A. and Ostry, J. (2011). *Inequality and Unsustainable Growth: Two Sides of the Same Coin?* Washington DC: IMF

<https://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf>

This paper highlights that while the evidence on the impact of initial inequality on growth has been mixed, the majority of empirical literature to date overlooks the fact that periods of rapid growth are interrupted by collapses and periods of stagnation. The authors argue that it is more relevant to assess the relationship between income distribution and these breaks in growth. The paper finds that while many developing countries have successfully initiated high levels of growth for a few years, the ability to sustain growth is much rarer. Longer periods of growth are found to be robustly associated with a more equal distribution of income, even when other determinants of growth duration (external shocks, initial income, institutional quality, macroeconomic stability, openness to trade) are taken into account. A key implication is that in the long term, policies to reduce inequality could result in sustained growth, or that reduced inequality and sustained growth may be viewed as 'two sides of the same coin'.

Berg, A., Ostry, J. and Tsangarides, C. (2014) *Redistribution, Inequality and Growth*. Washington DC: IMF <http://www.imf.org/external/pubs/ft/sdn/2014/sdn1402.pdf>

This paper builds on the tentative consensus in the literature that inequality reduces the pace and durability of growth, through mechanisms such as political instability and undermining progress in health and education. It uses a cross-country dataset that distinguishes market (before taxes and transfers) inequality from net (after taxes and transfers) inequality in order to test the effects of redistribution on growth. Firstly, the authors find that more unequal societies tend to distribute more. Secondly, the paper confirms that lower net inequality is robustly correlated with faster and more durable growth for a given

level of redistribution. Thirdly, redistribution is found to have little impact on growth, and it is only in the most extreme cases of redistribution that there is some evidence for a negative impact on growth.

van der Weide, R. and Milanovic, B. (2014). *Inequality Is Bad for Growth of the Poor (But Not for That of the Rich)?* Washington DC: World Bank

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6963>

Using US micro-census data from 1960-2010, this paper aims to 'unpack' inequality and growth to predict how different types of inequality can impact the subsequent income growth of different segments of the population. The authors find that high levels of overall inequality reduce the income growth of the poor and increase the income growth of the rich – i.e. the kind of growth that inequality stimulates creates further inequality. Total inequality is then split into 'top inequality' (inequality amongst the top 40 percent) and 'bottom inequality'. The study finds that both top and bottom inequality are negatively associated with income growth for the poor, and that bottom inequality is also positively associated with income growth for the rich. This may be because high levels of inequality, particularly among the rich, result in societal fragmentation. The authors argue that societal fragmentation could result in the rich opting out of publicly provided services such as education and healthcare and lobbying for policies which benefit themselves but limit growth opportunities for the poor (e.g. cuts to public health spending).

Additional resources

Banerjee, A. and Duflo, E. (2003). *Inequality and Growth: What can the data say?* Cambridge, MA: Massachusetts Institute of Technology

<http://economics.mit.edu/files/753>

Edward, P. and Sumner, A. (2014). *The Poor, the Prosperous, and the 'Inbetweeners': A Fresh Perspective on Global Society, Inequality and Growth?* Brasilia: International Policy Centre for Inclusive Growth

[http://www.kcl.ac.uk/aboutkings/worldwide/initiatives/global/intdev/people/Sumner/Inequality-Paper-\(10June2013\).pdf](http://www.kcl.ac.uk/aboutkings/worldwide/initiatives/global/intdev/people/Sumner/Inequality-Paper-(10June2013).pdf)

4 The ingredients of inclusive growth

The recognition that inequality affects the impact of growth on poverty reduction has led to a broadening consensus among policymakers that looking beyond a ‘growth-first’ agenda will be necessary to deliver inclusive growth in developing countries. The Asian Development Bank’s *Strategy 2020* (Zhuang, 2010) is indicative of this approach, and defines three policy pillars of an inclusive growth strategy:

- **High, efficient, and sustained growth to create productive jobs and economic opportunity:** As a means of creating opportunities for productive employment and generating revenues for governments to invest in their citizens, high and sustained growth is a necessary – but not sufficient – condition for inclusive growth.
- **Social inclusion to ensure equal access to economic opportunity:** This will require enhancing the human capacities of marginalised and disadvantaged sections of society – including women and young people – by providing access to education, health facilities, and infrastructure.
- **Social safety nets:** These are important to protect the chronically poor or those who cannot participate in the employment opportunities created by growth due to shocks beyond their control.

The focus on inclusiveness through equality of opportunity and social protection as well as economic growth is a clear departure from the ‘trickle-down development’ approach, and is backed up by evidence from developing Asia. Balakrishnan et al.’s 2013 study (reviewed in Chapter 3) has shown that increased fiscal spending on health, education and social safety nets while implementing measures to improve financial inclusiveness has helped make growth more inclusive.

Furthermore, the literature on what causes economic growth is both extensive and controversial. Duflo (2011) argues that balancing growth with equity (a key challenge for practitioners aiming to foster inclusive growth) will be achieved not by trying to affect the sources of growth, which is extremely difficult to do, but by implementing policies that enable poor people to access the opportunities created by growth whenever it happens.

Several studies have found that poorly designed policies to tackle inequality can result in further distortions in an economy that hinder growth and potentially increase poverty levels. Despite this, there is scope for ‘win-win’ policies such as better targeted subsidies and active labour market policies to promote employment, which address the fact that some of the constraints to growth also hamper the participation of the poor in the opportunities created by growth (Adedji, Du and Opoku-Afari, 2013; reviewed in Chapter 5). Other successful ‘win-win’ policies that can increase growth and opportunities for the poor simultaneously include those that address underlying market failures or asset inequalities (Ravallion, 2005; reviewed in Chapter 3).

In line with this broad approach, this chapter will examine a range of ‘ingredients’ that can contribute to inclusive growth. In addition, the further sources listed below will also be useful for practitioners aiming to gain a more general understanding of policies that can foster inclusive growth.

Additional resources

Commission on Growth and Development. (2008). *The Growth Report: Strategies for Sustained Growth and Inclusive Development*. Washington DC: Commission on Growth and Development

http://siteresources.worldbank.org/EXTPREMNET/Resources/489960-1338997241035/Growth_Commission_Final_Report.pdf

Zhuang, J. (ed.) (2010). *Poverty, Inequality and Inclusive Growth in Asia: Measurement, Policy Issues, and Country Studies*. Manila: Asian Development Bank.

<http://www.adb.org/publications/poverty-inequality-and-inclusive-growth-asia>

Duflo, E. (2011). *Balancing growth with equity: the view from Development*. Paper presented at the Jackson Hole Symposium, Federal Reserve Bank of Kansas City, August 1.

<https://www.kansascityfed.org/publicat/sympos/2011/2011.Duflo.Paper.pdf>

Stuart, E. (2011). *Making Growth Inclusive: Some lessons from countries and the literature*. Oxford: Oxfam International.

<http://policy-practice.oxfam.org.uk/publications/making-growth-inclusive-some-lessons-from-countries-and-the-literature-128736>

Anand, R., Mishra, S. and Peiris, S. (2013). *Inclusive Growth: Measures and Determinants*. Washington DC: IMF

<https://www.imf.org/external/pubs/ft/wp/2013/wp13135.pdf>

CAFOD. (2014). *What is “inclusive growth”?* London: CAFOD

<http://www.cafod.org.uk/content/download/17223/133621/file/Inclusive%20Growth%20full%20paper.pdf>

4.1 Productive jobs and labour

There is clear consensus among donors, practitioners and academics that creating productive employment is central to fostering inclusive growth. The *2013 World Development Report* (World Bank, 2013) states that countries should pursue an explicit jobs strategy rather than rely on growth-related policies to create jobs. This is because growth policies may not take into account the necessity of supporting women, young people and other vulnerable groups who may require specific support in entering the labour market.

As the private sector is likely to be the main source of productive employment, practitioners should take into account literature on private sector development when conducting interventions and devising policies. There is agreement among authors working in this area that systemic change should be implemented by altering the incentives for the private sector in order to bring about pro-poor or inclusive growth (OECD, 2006).

The literature also highlights the need for policymakers to recognise the important role of the informal economy in developing countries, and that steps should be taken to improve productivity and conditions in this sector while encouraging formalisation. Also emphasised is the need for governments to encourage growth in sectors of the economy with the potential to create high-productivity jobs (OECD, 2009). Further, the growing literature on inclusive innovation (see Heeks et al., 2012), which encourages the development of new goods and services for and/or by the poor, should be noted by practitioners or policymakers seeking to develop job strategies for inclusive growth.

Annotated bibliography

OECD. (2009). *Promoting Pro-Poor Growth: Employment*. Paris: OECD.

<http://www.oecd.org/dac/povertyreduction/43514554.pdf>

This report evaluates the role of employment in promoting pro-poor growth. It argues that productive employment is the main route out of poverty for most poor people, including those in fragile environments, and therefore needs to be the central objective of development cooperation. The authors emphasise the need for policymakers to recognise the size and importance of the informal economy in many developing countries, and the steps that need to be taken to increase productivity, working conditions and social protection in this area while implementing policies to encourage formalisation. The report highlights the need to expand the participation of women and young people in the labour market, through policies to address gender-based discrimination and provide vocational training. The need for a sound macroeconomic framework as a means of supporting growth and job creation, creating incentives to support socially responsible employment practices, and the importance of better statistics in understanding the functioning of labour markets are also explored.

OECD. (2006). *Promoting Pro-Poor Growth: Private Sector Development*. Paris: OECD.

<http://www.oecd.org/development/povertyreduction/36427804.pdf>

This report evaluates the role of private sector development in promoting pro-poor growth. While the private sector is widely recognised as the engine that drives the pace of growth, the way in which it develops also profoundly influences the pattern of growth. The authors identify a set of interlinked factors that must be in place for private sector actors, which include poor people, to benefit from the growth process. The correct incentives must be in place to promote entrepreneurship and investment, while competition and innovation should be encouraged to increase productivity. International trade must also be harnessed, markets made accessible to the poor (e.g. through access to banks and removing barriers to formalisation), and the risk reduced (e.g. through provision of insurance and savings products). It is also noted that donors should aim to improve the impact of private sector development on poverty reduction by bringing about systemic change rather than 'picking winners' in certain sectors viewed as essential for the poor.

Wong, P.K. (2012). *Innovation and Inclusive Growth in Emerging Economies (presentation)*. Singapore: National University of Singapore

http://www.oecd.org/sti/inno/Session_1_Poh%20Kam%20Wong.pdf

This presentation highlights that many emerging economies face the issue of having a significant proportion of their population in low-productivity sectors, while many SMEs lack scale to invest in innovation capabilities. Two innovation challenges for governments are outlined. Firstly, developing the capabilities of local firms to catch up technologically with global competition will be critical. This can be done through pooling the technological resources of SMEs in R&D consortia, or through technology 'ecosystems' via incubation and financing programmes. Secondly, addressing the social needs of the 'lower pyramid' population and speeding up structural transformation will be key. Policies to promote innovation for the lower pyramid include focusing public R&D spending on the lower pyramid and encouraging social entrepreneurship and new impact investment models to complement traditional public subsidies.

Additional resources

Heeks, R., Amalia, M., Kintu, R. and Shah, N. (2012). *Inclusive Innovation: Definition, Conceptualisation and Future Research Priorities* (Development informatics working paper no. 53). Manchester: Centre for Development Informatics

http://www.seed.manchester.ac.uk/medialibrary/IDPM/working_papers/di/di_wp53.pdf

4.2 Economic transformation

Studies agree that productivity enhancing structural transformations, which shift labour and resources from agriculture to more productive economic activities, are necessary components for sustained economic growth. Yet structural change can also hinder productivity and growth in developing countries, particularly in the context of an increasingly globalised world economy.

For example, McMillan and Rodrik (2011) find that structural change in developing country economies that have focused on exporting natural resources often reduces labour productivity, and intensified import competition as a result of trade liberalisation can result in displacement of workers and reduced growth. There is some consensus that policies that enable developing countries to maintain competitive exchange rates and flexible labour markets are likely to lead to structural transformations that increase productivity (McMillan and Rodrik, 2011; Martins and Lucci, 2013). However, there is mixed evidence that the conventional route of trade openness and financial liberalisation leads to an economic transformation that benefits the poor (CAFOD, 2014).

The Growth Commission report (2008) highlights several factors that policymakers should take into account to ensure structural transformations lead to inclusive outcomes. Among these are the need for policy experimentation, a focus on outcomes that favour the poor, and the need for stability and smooth transitions when implementing policies for economic transformation.

The literature also emphasises that shifting household livelihoods from subsistence agriculture to individual wage and salary employment takes generations, and the role of the non-agricultural informal economy as an intermediate stage in the process of economic transformation should not be overlooked (Fox and Pimhidzai, 2011). Finally, national economic transformations may also require global coordination on macroeconomic and financial policies, as highlighted in the paper by Martins and Lucci below (2013).

Annotated bibliography

McMillan, M. and Rodrik, D. (2011) *Globalization, Structural Change, and Productivity Growth*. Cambridge, MA: National Bureau of Economic Research.

<http://www.nber.org/papers/w17143.pdf>

Using sectoral and aggregate labour productivity statistics for 38 countries, the paper confirms that growth-enhancing structural change – the movement of labour and other resources from less productive to more productive activities – is a key driver of growth and development. However structural change in the context of intensified import competition caused by trade liberalisation can also cause displaced labour to move from high productivity to low productivity activities, as the least productive firms exit industries and others shed surplus workers. The authors find that differences in the pattern of structural change can explain the differences in economic performance between many Asian countries (where structural change has been increased productivity), and countries in Latin America and Africa (where structural change has led to decreased productivity). Countries that have maintained competitive exchange rates and flexible labour markets have been more likely to exhibit growth enhancing structural change. In contrast countries with a comparative advantage in natural resource exports tend to exhibit growth reducing structural change, as these industries do not generate much employment and cannot absorb the surplus labour from agriculture.

Fox, L. and Pimhidzai, O. (2011). *Is Informality Welfare-Enhancing Structural Transformation?*

Washington DC: World Bank.

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-5866>

Despite the strong growth performance and substantial reduction in poverty in sub-Saharan Africa (SSA) over the last decade, macro level studies (often using unsuitable traditional metrics and survey methods used in developed countries) have found little evidence of structural transformation in the region. Analysing Uganda as a case study, the authors use alternative benchmarks (focusing on household livelihoods rather than individual level employment) to argue that countries in SSA are undergoing structural transformations more suited to their initial conditions and often missed by macro indicators. This is demonstrated by the huge growth in informal firms outside the agricultural sector, which is viewed as an intermediate step on their transformation path rather than a symptom of a lack of transformation. This is because household level income gains fuelled by the productive informal sector will lead to productivity increases, savings and investment in human capital. The authors conclude that enabling households to diversify into the non-farm sector through productive informality will increase growth as well as allowing the majority of the population to take part in the growth process.

Martins, P. and Lucci, P. (2013). *Recasting MDG 8: Global Policies for Inclusive Growth*. London:

Overseas Development Institute.

<http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8216.pdf>

This paper explores the global economic policies which, if implemented, could stimulate inclusive growth in developing countries. The authors highlight three key areas in which global policies, rules and institutions can support national development efforts for stimulating inclusive growth. Macroeconomic policy coordination in the form of synchronised countercyclical fiscal and monetary policies, a new global reserve system, and exchange rate coordination will be vital in rebalancing the global economic system and addressing systemic crises. Finance-related policy measures such as an international liquidity buffer, measures to tackle illicit capital flows, alternative sources of development finance (e.g. global taxes and Special Drawing Rights), and strengthening investment standards will be necessary in promoting greater financial stability and increasing the availability of development finance. Finally, simplifying rules of origin and technical standards, mitigating the impact of commodity shocks and enhancing food security, reforming intellectual property rights, and scaling up aid-for-trade will help developing countries further integrate into the global trading system.

Additional resources

DCED. (2013, December 2013). Special Feature: Structural Transformation. *Latest Research and Evidence on PSD*. The Donor Committee for Enterprise Development.

<http://www.enterprise-development.org/page/download?id=2326>

ACET. (2014). *2014 African Transformation Report: Growth with Depth*. Accra: The African Centre for Economic Transformation

<http://africantransformation.org/wp-content/uploads/2014/02/2014-african-transformation-report.pdf>

4.3 Infrastructure

Infrastructure spending has been viewed as a prerequisite for economic development since Adam Smith, and most empirical studies have found that infrastructure has a significant positive effect on growth. Many studies take it as a given that, through its role in job creation and improvements in productivity, improving infrastructure will also lead to inclusive growth.

However, studies have shown major infrastructure programmes can often increase inequality despite boosting aggregate growth, as the centre of a country benefits significantly more than peripheral regions (Winters, 2014). For infrastructure to be used effectively as part of an inclusive growth strategy, practitioners should implement complementary policies as part of a broader development strategy to ensure the poor benefit (ADB, 2012; Winters, 2014). In particular, small-scale infrastructure projects are viewed as having a more direct positive impact on the lives of poor people (Jahan and McCleery, 2012).

Annotated bibliography

Asian Development Bank (2012). *Infrastructure for Supporting Inclusive Growth and Poverty Reduction in Asia*. Mandaluyong City, Philippines: Asian Development Bank.

<http://www.adb.org/sites/default/files/pub/2012/infrastructure-supporting-inclusive-growth.pdf>

This book starts from the premise that infrastructure is synonymous with development, and explores three key themes: the role of infrastructure in supporting inclusive growth, the need for ‘soft infrastructure’, and the role of public-private partnerships (PPPs) in infrastructure development. It is well established that infrastructure leads to inclusive growth as it creates jobs, reduces production costs, improves production capacity, and creates connections to new markets. The authors note that infrastructure investments have been shown to be most effective when accompanied by other interventions, such as education or health spending. The presence of soft infrastructure – the rules and regulations that govern the use and functioning of physical infrastructure – will also amplify the effects of infrastructure in promoting inclusive growth, by supporting efficient delivery. Finally, the authors recommend scaling up infrastructure-related PPP arrangements in Asia, as a means of decreasing the fiscal burden for governments and multiplying the impact of public sector resources.

Jahan, S. and McCleery, R. (2005). *Making Infrastructure Work for the Poor: Synthesis Report of Four Country Studies - Bangladesh, Senegal, Thailand and Zambia*. New York: UNDP.

<http://www.undp.org/content/dam/aplaws/publication/en/publications/poverty-reduction/poverty-website/making-infrastructure-work-for-the-poor/MakingInfrastructureWorkforthePoor.pdf>

This report first conducts a comprehensive review of the ‘infrastructure-poverty reduction-governance nexus’, highlighting mechanisms by which infrastructure can lead to growth and poverty reduction, and critical issues for project governance. Based on the findings from the four country studies, the authors then make a case for small-scale community-based infrastructure projects. They argue that they are more likely to have a direct positive impact on the lives of poor people while still complementing large-scale infrastructure initiatives. A key finding from the country studies is that small-scale infrastructure projects contribute significantly to reducing income poverty through increased wages and job opportunities. However, small-scale infrastructure was also found to positively impact the poor more broadly by reducing mortality rates, improving education, and empowering women. To maximise the impact of small-scale infrastructure, the authors recommend projects with complementary components or multiple objectives (e.g. a road that creates jobs, enables better access to education and health, and increases mobility for women).

OECD. (2006). *Promoting Pro-Poor Growth: Infrastructure*. Paris: OECD.

<http://www.oecd.org/dac/povertyreduction/36301078.pdf>

This report argues that economic infrastructure (e.g. transport, energy, ICT, water and sanitation) contributes to growth by lowering costs and raising labour productivity. Despite this, the IMF and World

Bank have found that annual investment in infrastructure in developing countries falls far short of the level required. The report recommends four principles for enhancing the contribution of infrastructure spending to pro-poor growth. Firstly, a country-led infrastructure framework linked to other economic and social development strategies should be used. Secondly, the investment in infrastructure should be targeted to impact as many poor people as possible, both as beneficiaries and in the implementation and maintenance of the infrastructure. Thirdly, promoting sustainability by emphasising infrastructure maintenance, helping partner countries establish systems to recover costs, and encouraging ongoing investment and adequate support services, will be critical. Finally, to encourage investment in infrastructure from governments and the private sector, donors should provide predictable and long-term investment using a range of financial instruments, accompanied by appropriate technical assistance.

Additional resources

Winters, A. (2014). *Globalization, Infrastructure, and Inclusive Growth*. Tokyo: Asian Development Bank Institute.

<http://www.adbi.org/working-paper/2014/02/24/6176.globalization.infrastructure.inclusive.growth/>

4.4 Human development

Investment in human capital is recognised as fundamental for inclusive growth. Labour is poor people's main asset, so good levels of health and education enable poor men and women both to participate in and profit from economic growth when it occurs (Duflo, 2011; CAFOD, 2014). Further, according to the broad definition of inclusive growth, good education and access to healthcare are seen as human development outcomes in themselves, as well as instruments for reducing income poverty (McKinley, 2010).

Empirically, there is a wealth of evidence which links spending on human capital to better economic outcomes for the poor. Econometric results suggest that boosting social sector spending by about 1 percent of GDP is associated with about 0.5 percentage point decline in the poverty rate (UNESCO, 2007; Hull, in OECD, 2009; Anand, Tulin and Kumar, 2014).

Practitioners should note that it is important for policies addressing human development to be implemented in line with other complementary policies, taking into account the connections between education and skills training and jobs in particular. While there are a range of sources which emphasise the importance of education and skills training in fostering pro-poor or inclusive growth, there is currently a gap in the literature on the relationship between healthcare and inclusive growth.

Annotated bibliography

Klump, R. and Cabrera, C. (2007). *Education and Pro-Poor Growth*. Frankfurt: KfW Bankengruppe.

https://www.kfw-entwicklungsbank.de/Download-Center/PDF-Dokumente-Diskussionsbeitr%C3%A4ge/49_AMD_E.pdf

This paper explores the role of education in facilitating pro-poor growth. On a micro level, education improves the productivity and employment potential of poor people. It also affects their ability to participate in the political process, which should increase government accountability and protect them from pro-rich policies. Expenditure on education is especially enhanced by complementary policies in healthcare and nutrition, as well as targeted interventions. At a macro level, most studies find a positive relationship between the initial level of education and subsequent economic growth. The authors conclude that unequal educational distributions lead to unequal income distributions, and that higher levels of human capital are positively related to the growth of poor people's incomes. Investment in education in low- and middle-income countries should be directed towards primary education, as this leads to the highest returns for pro-poor growth.

UNESCO. (2007). Investing in Skills for Prosperity. In *Youth and Skills: Putting Education to Work* (chapter 4). Paris: UNESCO.

<http://unesdoc.unesco.org/images/0021/002180/218003e.pdf>

What is the value of investing in skills for prosperity? This report notes that for \$1 spent on education, \$10-\$15 dollars are generated in economic growth. The results of varying levels of investment in education in different countries are compared. The authors then note that despite the clear economic benefits of investing in skills, it is often neglected or low priority in many national development plans. To develop an effective skills strategy which aims to reach the most disadvantaged, a large number of providers need to be included. The report also highlights that skills development programmes are usually only relevant to jobs in the formal sectors and are not targeted towards the skills required in the informal sector, where a lot of employment is to be found in developing countries. Disadvantaged youth should also be included in the planning process for skills training as they have a deeper understanding than policymakers of the realities of their own lives. Finally, the report emphasises the importance of donors investing in education and skills, as primary and secondary education is being squeezed in many developing country government budgets.

4.5 Fiscal policy

Fiscal policy encompasses taxation and government spending, and is the most direct tool that governments have to undertake redistributive policies (IMF, 2014). The ADB (2014) has found that government expenditure is a more effective fiscal tool than taxation as it can target low-income groups directly, and that government investment in the human capital of the poor is fundamental for inclusive growth.

The role of fiscal policy in generating funds for spending on infrastructure, social protection and human development is also noted by numerous authors, who particularly emphasise the need for governments to broaden their tax base in order to continuously finance policies that foster inclusive growth (Duflo, 2011; ABD, 2014; IMF, 2014).

Annotated bibliography

Asian Development Bank. (2014). *Asian Development Outlook 2014: Fiscal Policy for Inclusive Growth*. Mandaluyong City, Philippines: Asian Development Bank.

<http://www.adb.org/sites/default/files/pub/2014/ado-2014.pdf>

The ADB recommends that policymakers use fiscal policy to foster equality of opportunity. In order to maintain fiscal prudence, this will require calibrating spending to better meet the needs of the poor and mobilising a larger tax base. This brief states that government expenditure is a more effective fiscal policy tool than taxation for reducing inequality. Government expenditure on education and healthcare is recommended as a means of directly advancing the well-being of the poor while improving their productive capacity; targeted subsidies and transfers are promoted as a way of protecting the most vulnerable; and spending on public infrastructure is seen as a means of enabling the poor to take better advantage of improved healthcare and education. The ADB notes that Developing Asia will need to expand its fiscal resource base in order to fund this kind of spending. This will require broadening the income tax and VAT base, but also exploring corrective taxes, property taxes, capital gains and inheritance tax mechanisms to make the tax structure more progressive and equitable.

IMF. (2014). *Fiscal Policy and Income Inequality*. Washington DC: IMF.

<http://www.imf.org/external/np/pp/eng/2014/012314.pdf>

This report argues that fiscal policy is the main tool that governments have to influence income distribution. However, in a period of fiscal consolidation (as is still the case globally) governments must

carefully balance their distributional and efficiency objectives through carefully designed spending and taxation policies. There are nevertheless policies that address inequality which minimise negative efficiency impacts. In developing countries, the authors recommend: consolidating social assistance programmes and improving targeting; introducing and expanding conditional cash transfer programmes as administrative capacity improves; expanding non-contributory means-tested social pensions; improving the access of low-income families to education and health services; and expanding coverage of personal income taxation.

4.6 Social protection

The literature outlines two key, linked roles that social protection plays in contributing to inclusive growth. Firstly, it acts as a means of protecting the poorest and most vulnerable in society from shocks and crises, which is critical in limiting the need for poor families to sell assets or disengage from other productive activities (UNDP, 2011; Mathers and Slater, 2014). Secondly, it can contribute to the growth process by fuelling a cycle of consumption and enabling poor entrepreneurs to take more risks (UNCTAD, 2006; OECD, 2009). A much cited example of this is the Bolsa Familia conditional cash transfer scheme in Brazil (OECD, 2013). There is stronger empirical evidence to show that social protection programmes have a positive impact on measurable service delivery and human development outcomes, such as health and education, while their effects on longer-term social development goals and economic growth rates are less clear (Browne, 2015). While social protection alone will be insufficient to lift households out of poverty there is consensus that it is an important ingredient in fostering inclusive growth, particularly in the broader sense (see McKinley definition in Chapter 2).

The literature in this area emphasises the need for donors to support developing country governments in the design and implementation of social protection schemes, as the programmes need to be tailored to the needs of each country (Mathers and Slater, 2014; OECD, 2009).

Annotated bibliography

Mathers, N. and Slater, R. (2014). *Social Protection and Growth: Research Synthesis*. London: Overseas Development Institute.

<http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9099.pdf>

This review paper evaluates a range of academic and practitioner literature with the aim of identifying the channels through which social protection policies impact growth and productivity. The authors find that the literature demonstrates that social protection is a key instrument for promoting inclusive growth, and can contribute marginally to aggregate growth. The impact of social protection is particularly strong at the micro, or household level, where it can play an important role in limiting the use of negative coping strategies, such as removing children from school to work, or selling important assets. Further, social protection policies can have a multiplier effect at a local level by enabling increased consumption and improved labour market outcomes. It is noted that there is substantial evidence to show that social protection in low- and middle-income countries does not lead to dependency (i.e. less labour market participation or productivity). Regarding design and implementation of social protection programmes, the authors highlight that identifying the most appropriate type, size and duration of transfers will be key, as well as ensuring that transfers are long term and predictable.

OECD. (2009). *Promoting Pro-Poor Growth: Social Protection*. Paris: OECD.

<http://www.oecd.org/dac/povertyreduction/36301078.pdf>

This report highlights the fundamental contribution of social protection – defined as social insurance, social transfers and minimum labour standards – in promoting pro-poor growth. It argues that social protection not only protects the poorest and most vulnerable from crises, natural disasters and climate change, but also stimulates pro-poor growth by enabling poor households to invest in productive

activities and human capital. Studies have shown that social protection is affordable even for low-income countries, and the report notes that costs can be managed by starting with a limited programme and scaling up once more resources are available and impact has been demonstrated. A rights-based approach to social protection which seeks to address vulnerability throughout a citizen's lifetime is advocated, and it is noted that effective social protection frameworks will require a comprehensive list of instruments which appropriately address coverage and targeting. Finally, the authors note the central role of donors in supporting the capacity of governments in planning, financing, delivering and monitoring social protection programmes.

For further resources, see Browne, E. (2015). *Social Protection: Topic Guide*. Birmingham: GSDRC, University of Birmingham

4.7 Institutions

See Section 5 – *The politics of inclusive growth*.

5 The politics of inclusive growth

The design and implementation of policies to promote inclusive growth will not take place in a vacuum. Khan (2012) argues that the political settlement, the ‘combination of institutions and organisations that can reproduce itself over time’, defines the boundaries of possible change in any given society. Policies that succeed in fostering inclusive growth will therefore require the correct combination of political institutions to sustain them.

Many academics, donors and policymakers have argued from a conceptual standpoint that inclusive growth will require inclusive institutions which enable all citizens to hold their governments accountable. Inclusive institutions can be defined as those that grant equal rights and enable equal opportunities, and are based on principles of universality, non-discrimination, or targeted action (Carter, 2014). This accountability is viewed as important in stopping the policymaking process from being captured by vested interests (OECD, 2014; Zhuang et al., 2010). The World Bank (2013, reference in section 1.2) also emphasises that inclusive growth requires the participation of all groups, including the poorest and most marginalised, in decision-making processes.

Further, Birdsall (2010) argues that sustained growth is more likely where a politically salient middle class demands the stable political and economic institutions that encourage investment by ensuring the rule of law and recognition of private property rights. Finally, some authors view inclusive institutions as basic development outcomes rather than just as a means to poverty reduction (Zhuang et al., 2010). However, in reality institutions rarely fit completely into ‘inclusive’ or ‘exclusive’ categories, and some institutions may exclude certain groups from certain resources and rights while enabling them to access others (Carter, 2014).

Empirically, there is little evidence to demonstrate that inclusive institutions are a prerequisite for economic growth that stimulates productive employment (Pritchett and Werker, 2012). More significant is the ability of the state (through its institutions) to enact policies that are growth enhancing and promote increases in productivity. Practitioners should note the experience of China, which has significantly reduced absolute poverty without establishing what can be formally described as inclusive institutions (OECD, 2014).

Similarly, while some authors find that there is a two-way causal relationship between institutional quality and inclusive growth, it is less clear which types of institutional improvements (e.g. voice and accountability or rule of law) result in sustained and inclusive growth (Zhuang et al., 2010). This is in line with Khan’s (2012) argument that all-encompassing good governance reforms are difficult to implement in developing countries due to the nature of their political settlements, and that care needs to be taken to identify the specific institutional solutions that can be implemented under specific political settlements.

Annotated bibliography

OECD. (2014). Making Inclusive Growth Happen: The Role of Institutions. In *All on Board: Making Inclusive Growth Happen* (chapter 4). Paris: OECD.

<http://www.oecd.org/inclusive-growth/reports/All-on-Board-Making-Inclusive-Growth-Happen.pdf>

This report explores the role of institutions in fostering inclusive growth. It emphasises that inclusive institutions are particularly important as political and economic inequalities often reinforce each other. This can lead to some socioeconomic groups being over-represented in the design and implementation of economic and social policies, and at worst can lead to the capture of policymaking by the most privileged

groups (resulting in pro-rich policies). As such, an inclusive policy process will require effective and representative citizen participation and checks and balances to curb the influence of vested interests. This type of inclusive policy process acts not only to increase inclusiveness, but also improves efficiency: it mitigates service failures and improves policy outcomes. The authors also note the need for governments to use new technologies to engage with citizens, as well as the need for effective decentralisation to sub-national institutions, in order to foster institutions and policies that lead to inclusive growth.

Khan, M. (2012). *The political economy of inclusive growth*. In *Promoting Inclusive Growth: Challenges and Policies*. Paris: OECD.

http://www.oecd-ilibrary.org/economics/promoting-inclusive-growth/the-political-economy-of-inclusive-growth_9789264168305-3-en

What kind of political settlement is required to foster inclusive growth? This paper argues that achieving inclusive growth in developing countries will require institutional solutions to address market failures (e.g. governance reforms to strengthen property rights), to facilitate competition in global markets. However many of these ‘good governance’ reforms are difficult to implement in developing countries due to the nature of their political settlements, which are often variations of clientelism, with numerous informal institutions and arrangements. This is because a particular institution that suggests an allocation of benefits that differs from the distribution of power sustained by a political settlement is likely to be resisted by informal arrangements. The author therefore argues that fostering and sustaining inclusive growth will require specific institutional solutions to market failures that can be applied under particular political settlements.

Zhuang, J., De Dios, E. and Lagman-Martin, A. (2010). *Governance and Institutional Quality and the Links with Economic Growth and Income Inequality: With Special Reference to Developing Asia*. Mandaluyong City: Asian Development Bank.

<http://www.adb.org/sites/default/files/pub/2010/Economics-WP193.pdf>

This study finds that countries in developing Asia with government effectiveness, regulatory quality, and rule of law at above the global mean in 1998 grew faster in the next decade than countries below the global means for those dimensions of good governance. However, no such causal link was established for voice and accountability, political stability and control of corruption. Various explanations are explored for this including problems with measurement, the role of informal institutions and the context specific nature of the relationship between institutions and growth. Similarly, no clear relationship is found linking governance and institutions with inequality in the sample of Asian countries. Despite this, the authors argue that the value of good governance and inclusive institutions is intrinsic and underlies the notion of inclusiveness, and as such they should be pursued as a basic development goal. Strengthening government effectiveness and improving regulatory quality and rule could be used as entry points for development strategies in developing Asia.

Pritchett, L. and Werker, E. (2012). *Developing the guts of a GUT (Grand Unified Theory): elite commitment and inclusive growth*. Manchester: ESID.

http://r4d.dfid.gov.uk/PDF/Outputs/ESID/esid_wp_16_pritchett_werker.pdf

Why are some countries able to initiate periods of rapid growth while other undergo periods of stagnation, and why are some able to sustain growth over decades while others see growth reverse or stagnate? This paper finds a high level of variance in growth rates between countries with the same quality of institutions, and that many countries with high and sustained growth rates have weak institutions (across a variety of indicators). The authors argue that only highly developed nations have been able to develop institutions that create and enforce ‘rules’ – which are impersonal and apply equally to everyone. It is not the inclusive nature of the institutions, or the ability to enforce good rules, that result in rapid or sustained growth and structural change. Arguably, it is the shift to an environment in which ‘deals’ can be made in an ordered and stable manner which leads to growth and increased productivity.

Additional resources

Thorbecke, E. (2014). *The structural anatomy and institutional architecture of inclusive growth in sub-Saharan Africa*. Paris: OECD.

<http://www.oecd.org/inclusive-growth/reports/All-on-Board-Making-Inclusive-Growth-Happen.pdf>

Bluhm, R. and Szirmai, A. (2012). *Institutions and long-run growth performance: An analytic literature review of the institutional determinants of economic growth*. Maastricht: Maastricht Graduate School of Governance.

<http://portal.unu.edu/calendar/?go=event.page&id=4813>

Birdsall, N. (2010). *The (Indispensable) Middle Class in Developing Countries; or, The Rich and the Rest, Not the Poor and the Rest*. Washington DC: Centre for Global Development.

<http://www.cgdev.org/publication/indispensable-middle-class-developing-countries-or-rich-and-rest-not-poor-and-rest>

Acemoglu, D. and Robinson, J. (2012). *Why Nations Fail: The origins of power, prosperity, and poverty*. New York: Crown.

<http://whynationsfail.com/>

Kjaer, A. (2014). From 'Good' to 'Growth-Enhancing' Governance: Emerging Research Agendas on Africa's Political-Economy. *Governance in Africa* 1(1): 2, 1-10

<http://dx.doi.org/10.5334/gia.ac>

For further resources, see Carter, B. (2014). *Inclusive Institutions: Topic Guide*. Birmingham, UK: GSDRC, University of Birmingham.

6 Measuring inclusive growth

It is evident from the literature that measuring inclusive growth, both at the country and programme level, is challenging. This is due to the absence of a clear and unanimous definition of inclusive growth and the lack of robust data required to measure, monitor and evaluate the implementation of inclusive growth policies and programmes (McKinley, 2010; Klasen, 2010).

Despite this, there is some consensus on the methods required to analyse inclusive growth, and how this should differ from analysis and measurement of pro-poor growth. The need for an *ex ante* analysis that examines ways to increase the pace of growth by involving underused sections of the labour force is emphasised, rather than *ex post* tracking of poverty measures to observe the impact of growth on poverty reduction (which is how pro-poor growth is typically measured) (World Bank, 2009; Ianchovichina and Lundstrom, 2009).

Further, unlike measuring pro-poor growth, measuring inclusive growth requires measuring participation in the growth process using indicators such as employment to population ratio (Ramos, Ranieri and Lammens, 2013) or the share of workers in families below the poverty line (McKinley, 2010). This analysis of both process and outcomes differentiates the measurement of inclusive growth from that of pro-poor growth.

Practitioners should note that the majority of the sources highlighted below focus on measurement of inclusive growth at the country level. The Klasen (2010) paper provides a starting point for measuring inclusive growth at the project or programme level, but this area represents a current weakness in the literature.

Annotated bibliography

Ianchovichina, E. and Lundstrom, S. (2009). *Inclusive Growth Analytics: Framework and Application*. Washington DC: World Bank.

<http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-4851>

This paper highlights the need to use different *ex ante* frameworks to assess inclusive growth, depending on the economic context of a particular country. In a country where income levels, growth and investment are low, the authors recommend the use of the Hausmann, Rodrick and Velasco's (2005) heuristic approach to identifying the most binding constraint to growth. This is because growth is likely to be the main driver of poverty reduction. When growth is high but poverty reduction has stagnated, the authors outline an inclusive growth analytics framework which should be used. First, this requires a background analysis of the historical growth and poverty reduction trends in the country, including challenges and opportunities for economic transformation and diversification. Secondly, a profile of economic actors is compiled, enabling practitioners to identify the activities that different groups are engaged in and their potential for growth. Finally, an organisational framework should be used to identify the constraints to inclusive growth for these actors. The authors apply this framework to the case of Zambia.

Klasen, S. (2010). *Measuring and Monitoring Inclusive Growth: Multiple Definitions, Open Questions, and some Constructive Proposals*. Mandaluyong City, Philippines: Asian Development Bank.

<http://www.adb.org/sites/default/files/pub/2010/ADB-WP12-measuring-inclusive-growth.pdf>

What indicators should be used to monitor inclusive growth at the country, programme or project level? After defining inclusive growth and reviewing the existing literature on the topic, Klasen emphasises that inclusive growth should be measured both by process and outcomes. Formally, an instance of inclusive growth at the country level is defined as one that exhibits: positive per capita income growth rates; income growth rates for predefined disadvantaged groups at least equal to per capita rates; and expansions of non-income dimensions of well-being for disadvantaged groups that exceed the average rate. At the programme or project level, country level indicators are deemed too crude to measure

inclusive growth. Instead, the focus should be on assessing the project's goals in regard to beneficiaries and comparing this data to an inclusive growth agenda. This can be done by defining indicators such as: 'Does the project/programme aim to, and be likely to lead to increased employment of poor people (using the \$2.50/day indicator)?'

McKinley, T. (2010). *Inclusive Growth Criteria and Indicators: An Inclusive Growth Index for Diagnosis of Country Progress*. Mandaluyong City, Philippines: Asian Development Bank.

<http://www.adb.org/sites/default/files/pub/2010/ADB-WP14-inclusive-growth-criteria.pdf>

This paper outlines a composite inclusive growth index at country level, consisting of indicators in the areas of: (1) growth, productive employment, and economic infrastructure; (2) income poverty and equity, including gender equity; (3) human capabilities; and (4) social protection. The index can be used as a diagnostic tool for assessing country progress on inclusive growth, or as an initial framework to assess the alignment of donor (in this case the ADB's) assistance to a country's strategic priorities.

Ramos, R., Ranieri, R. and Lammens, J. (2013). *Mapping Inclusive Growth*. Brasilia: International Policy Centre for Inclusive Growth.

<http://www.ipc-undp.org/pub/IPCWorkingPaper105.pdf>

While acknowledging the lack of a clear definition of inclusive growth, this report attempts to comprehensively measure inclusive growth at the country level using three indicators: poverty, inequality, and the employment to population ratio (EPR). The authors highlight that poverty and inequality are already established as measures of pro-poor growth and inclusive growth from an outcomes perspective, and that it is EPR that adds an inclusive aspect to this measure through its participatory focus. EPR is used as a proxy for economic participation, as productive employment is poorly defined and difficult to operationalise due to lack of data. The analysis shows that most developing countries have managed to increase their level of inclusiveness due to a decrease in poverty levels and no increase in inequality. The authors argue that this increase in inclusiveness cannot be explained by economic growth, as some countries showed high increases in inclusiveness with low growth, and some of the countries with the worse inclusiveness performances had very high growth rates.

Additional resources

Deloitte. (2012). *Broad-based economic growth diagnostics*. New York: Deloitte.

<http://www.deloitte.com/assets/Dcom->

[UnitedStates/Local%20Assets/Documents/Federal/us_fed_Broad_Based_Growth_Diagnostic_080212.pdf](http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Federal/us_fed_Broad_Based_Growth_Diagnostic_080212.pdf)

Adedji, O., Du, H. and Opoku-Afari, M. (2013). *Inclusive Growth: An Application of the Social Opportunity Function to Selected African Countries*. Washington DC: IMF

<http://www.imf.org/external/pubs/ft/wp/2013/wp13139.pdf>

OECD. (2006). *Promoting Pro-Poor Growth: Harmonizing Ex Ante Poverty Impact Assessment*. Paris:

OECD. <http://www.oecd.org/dac/povertyreduction/39135680.pdf>