Conteh, Alieu; Gangopadhay, Shubhashis; von Braun, Joachim; Wihlborg, Clas

Conference Paper

Growth through poverty reduction and financial inclusion

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Growth through Poverty Reduction and Financial Inclusion

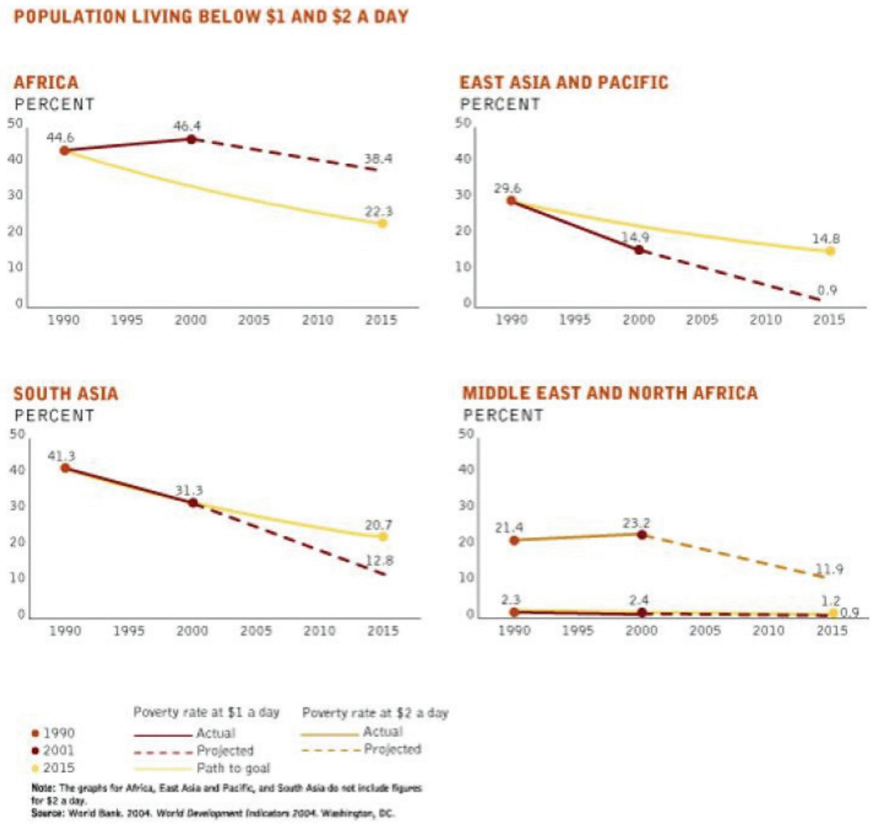
The Challenges

In most developing countries, governments undertake large poverty alleviation programs whereby specific goods and services are transferred to those who are unable to afford them in the free market. These programs are targeted (at the poor) and conditional (for particular goods and services). But targeting generates incentive problems (the poor have reduced incentive to become productive) and leakage (some people receive benefits even though they do not need them and others who need them do not receive them).

Conditionality gives rise to monitoring and enforcement problems, leading to opportunities for corruption. Furthermore, governments face the problem of making the goods and services available at the right time in the right place. These various problems reduce countries' growth potential and hinder poverty alleviation.

Should traditional government in-kind subsidies to the poor be replaced by cash transfers to the poor? Should the cash transfers be conditional (for specific goods and services) or unconditional?

Should unconditional cash transfers be combined with a negative income tax, leaving the government to focus on regulatory activities? What is the role of new technologies, such as biometric smart cards and electronic bank accounts in implementing such an approach? If such changes are desirable, what are the concrete institutional and policy changes required?



Source: World Bank, World Development Indicators 2004
Note: The graphs for Africa, East Asia and Pacific, and South Asia do not include figures for $2 a day.

Can market-friendly mechanisms be designed that enable households and businesses, in the pursuit of their own interests, to reduce poverty by stimulating growth?

Can poverty be effectively reduced through profitable business activity that promotes financial inclusion? Can new financial instruments facilitate such a process? What, for example, is the

future of micro finance and how can its effectiveness be improved? What legal and regulatory framework and what international support is required for such opportunities to be exploited?

Proposed Solutions

Alieu Conteh

Chairman of the Board, African Wireless

Introduction

Poverty is a widespread phenomenon in most developing countries. It is particularly prevalent in rural areas, although its incidence in urban areas also increases.

The perceptions of the poor regarding poverty differs depending on where the respondents live. The key factors for the urban poor are:

- low purchasing power,
- old age, and
- large family size.

Poor people in rural areas, however, attribute their situation mainly to

- laziness or lack of initiative,
- persistent failure,
- physical handicaps, and
- social decay.

Economic development requires a lot of capital which most developing countries fail to accumulate by themselves and therefore leaving them with no choice but to resort to foreign loans, aids, and investment in order to acquire some of it.

We also all know that to attain growth there should be also a lot of economic production (this implies there should be a lot of productive activities). Direct consumption alone cannot generate a healthy growth. It is true that social consumption (welfare and relief programs) by amplifying the demand can generate some limited growth.

Most developing countries have the four factors of production: natural resources (land, water, and minerals), human resources (in abundance but skills still is a problem), capital (limited infrastructure, limited credit facilities) and entrepreneurship (exist but not correctly incentivized through right legislations, laws, policies and regulations).

The possible solutions for poverty clearly depend on what is chiefly causing it, and this can clearly vary with time and with place.

Growth through poverty reduction and financial inclusion 2010

Grow through poverty reduction and financial inclusion can be based on seven major principles that can underpin any government's actions in the future:

1. Promotion of good governance.
2. Participation of women.
3. Consideration of regional disparities.

4. Redefinition of the role of the state.
5. Sustainable development of natural resources.
6. Promotion of a new partnership between the state and donors.
7. Continuation of the process of integration within regional economic and monetary unions.

The strategy hinges on the following four major objectives:

- Accelerate equity-based growth.
- Guarantee that the poor have access to basic social services.
- Expand opportunities for employment and income-generating activities for the poor.
- Promote good governance.

The four major objectives

1. Accelerate equity-based growth

Acceleration of growth is a prerequisite for reducing poverty. The implementation of major structural reforms is required in order to more fully open up the economy to the outside, lower production costs while improving factor productivity, encourage initiative, and support activities to generate income and create jobs, particularly in rural areas.

Government needs to invest in infrastructure because business needs better transport systems, railroads, better communications networks. These can all be prompted in full or part by government and they can generate business for small and large companies.

Government needs to put together financial strategy that will bring about more loans for small and medium sized enterprises. Government needs to encourage venture capital funds, business angels and banks to invest in or lend to smaller enterprises and start-ups. This is risky so the government can help lay off some of the risk.

Government needs to make it as easy as possible to start a new business, reduce administrative and tax on new business.

2. Guarantee that the poor have access to basic social services

Poverty is linked to geography. In the same country you have more gifted regions and left gifted one. You have also rural and urban difference in poverty. Even in urban areas you have rich commune and poor suburban areas.

In recognition of the remarkably uneven distribution of poverty across any country, and limited resources available, there is a need to set up targeting approach in order to disburse the maximum funds to areas of the greatest need.

Policies need to be adopted directly targeting the poor by helping them access essential social services:

- basic education,
- health,
- clean water, and
- sanitation.

Expand opportunities for employment and income-generating activities for the poor.

Development fund shall be used first to produce construction projects, and provide basic education, health care and so forth. Public employed projects shall be established in designated poor areas for poor people to work for food or to acquire any basic needs.

3. *Offering them expanded employment opportunities*

Expand opportunities for employment and income-generating activities for the poor

To this end, each Government needs to:

- accelerate the required institutional reforms, and
- enhance the effectiveness of public expenditure.

Reforms to increase the ability of the poor to participate in growth will focus on creating conditions necessary to facilitate the accelerated growth of the agricultural sector.

4. *Promote good governance*

Good governance is a key component of its poverty reduction strategy. Therefore accelerating reforms to strengthen democratic forums and promoting the efficient management and transparency of government finance is the key of success.

Conclusion

In order to combat poverty it is essential to establish priorities. Priority sectors can be:

- **the social sectors:** basic education, health, drinking water, and sanitation;
- **rural development:** agriculture, livestock breeding, agricultural water works, rural roads.

These sectors will receive increased attention as the poverty reduction strategy is implemented. Programs for these sectors will be implemented via new modalities involving NGOs and local communities when such modalities are more effective than government structures.

Shubhashis Gangopadhyay

Research Director and Management Trustee, India Development Foundation; Professor, University of Gothenburg, Sweden

Much of poverty is the incidence of a lack of education, nutrition and general health. If minimum levels of these services are available to all, and the (labor) markets do not have barriers to entry, then much of the problem of chronic poverty could be mitigated.

- These services are fundamental rights of citizens and governments have to ensure that everyone has access to them. It is erroneous for the government to target specific subgroups to whom these services are guaranteed.
- These services should not be provided directly by the state, e.g., through government run schools and hospitals, but by providing vouchers to the poor so that they can access these services from private providers.
- Instead of targeting these vouchers to specific groups of people, the government should develop self-selection mechanisms that keep those who can afford these services away from these subsidies.
- And, unconditional cash transfers are more efficient than transfers conditional on the use of specific services.

The other major issue in poverty is the lack of access to financial markets and limited or no access to financial instruments like savings, credit, insurance, education loans, etc. Part of the problem is structural. A daily laborer is unable to access banking services during working hours but banks do not remain open when he, or she, is not at work. Even if daily laborers can make it to the formal financial institution, the institution is not interested in their business since their low levels of demand is not sufficient to compensate institutions for the lumpy transaction costs of doing business with small players. And, of course, part of the problem is the lack of

instruments that are of value to the poor, e.g., collateral free loans for those who have no tradable assets.

- Technology can help in solving some of the structural problems, for example through mobile phone bank accounts.
- Instead of intervening in the activities of existing institutions, the society needs to design institutions and instruments that can scale down the transaction costs of small deals and make such activities profitable, and hence, commercially viable. This is where innovation plays a significant role.
- Micro-finance, micro-insurance, micro-pension organizations have gone a long way in promoting financial inclusion. However, it is not clear that these institutions have reached the poorest among the poor. One needs to build on the lessons learnt from the activities of these organizations to make the final push towards those currently left out.
- The government should focus more on developing mechanisms that enable market solutions through the development of innovative instruments and (credible) institutions rather than directly intervene through, e.g., subsidizing interest payments for loans taken by the poor, guaranteeing collateral free loans, etc.

Joachim von Braun

Director, Center for Development Research (ZEF); Professor for Economics and Technical Change, University of Bonn

The focus of the solutions proposed here is not on general poverty reduction, but on the extreme poor and marginalized, i.e., those far below the poverty lines.

Extreme poverty is a huge humanitarian issue, but also the largest market failure, as human potentials and productivity are wasted. It must be noted that

1. The poorest are becoming increasingly concentrated in Sub-Saharan Africa and South Asia.
2. Poverty and widespread hunger remain even in regions that have experienced rapid economic growth and substantial reductions in poverty.
3. A twin problem needs to be addressed: The urban poor are increasing in number and the prevalence of hunger is increasing in urban areas, while the poor are still predominantly rural. Poverty reduction remains strongly connected to agricultural development in many countries.
4. Poverty and hunger reduction has been slower among the poorest and among excluded groups—ethnic minorities, disadvantaged people, and the disabled—causing poverty and hunger to be increasingly concentrated in these groups. In addition, poor women and children are particularly vulnerable to the long-term effects of poverty and hunger for health and education.
5. Although the total number of people in poverty may change little, this stability masks substantial movements in and out of poverty. Some above the poverty line are vulnerable to become poor, and some below the line may move out of poverty. Others far below the line (usually the very poorest) will be there for longer, perhaps for generations.
6. New risks are arising for the poor, for instance due to climate change, economic imbalances, and health crises.

Areas of action to accelerate reduction of extreme poverty and marginality include technical and institutional elements:

1. Focusing on inclusive growth—a different pattern of growth, that includes the poorest and hungry from the beginning, is needed.

2. Improving access to assets and markets—appropriate property rights are needed to address inequality in assets. Millions of small farmers need improved access to value chains, and many poor households need access to nonfarm rural employment.
3. Phasing in social protection more quickly and comprehensively—policies that encourage "pro-poor" growth need to be re-balanced with social protection policies.
4. Accelerating investments in health and nutrition programs, particularly for children and women
5. Including the excluded—the above-mentioned actions all require an effective state that is responsive to the needs of the poorest and the socially excluded. Actions to empower women are also particularly important to ensure their full participation.

Two specific action areas shall be emphasized against this background:

Action to achieve more with the limited resources: Reduction of extreme poverty through enhanced public services and decentralization.

Reforming public services such as health, nutrition, education or agricultural extension by decentralizing or re-centralizing service functions to different levels of local government is a most significant political process for poverty reduction. Likewise, it is a political process to mobilize service users, especially the rural poor, to effectively use the political space that decentralization can create.

Poverty reduction policy should focus more on these issues, than designing often non-sustainable programs supported with extra budgetary resources.

Which level of decentralization is appropriate to ensure better public service provision (for each relevant service) for the poor? And by which political process can necessary reforms be achieved?

Sound economic policy must guide pro-poor services: Assessing the costs, including the transaction costs, at which a service of a defined quality, quantity and pro-poor outcome can be provided, makes it possible to evaluate trade-offs that arise in assigning service transactions to different levels of government. One needs take into account the costs incurred by service providers as well as the costs incurred by service users. This perspective makes it possible to ensure pro-poor outcomes and accounting for total costs. The more cost-effective a service can be provided to the poor, the easier it is to reach a larger number of the poor with limited public resources, i.e., to move from one-size-fits all or best practice to good fit approaches.

A large scale capacity building program by multi-lateral and bi-lateral development agencies is needed to enhance the public services that cater to the extreme poor.

Action to address ultra-poverty and marginality through new players, i.e., social venture capital funds.

Ultra-poverty and marginality in developing countries needs to be addressed by going far beyond typical poverty reduction actions. By approaching the persistent problems of extreme poverty through the lens of marginality, features and causes of extreme poverty are put up front, rather than as secondary step to define potential investment actions.

Marginality describes people and communities, in situations affected by circumstances and in places at the edge of economic, ecological, social and political systems. Most of the extremely poor are marginalized, but not all marginalized are extremely poor.

Investing in the ultra poor has large economy wide gains. Public institutional frameworks should be supported, that facilitate social venture capital funds to invest in the ultra poor. Where should social entrepreneurs and venture investors best place their investments? Action research needs to pave the way. Potential specific investment options are technological, institutional or financial and must respond to the specific features, capacities and capabilities of the marginalized communities, which depend on their endowments.

Customizing an optimal investment or incentive packages for marginalized communities can be seen within a framework in which investments are designed according to the varying capacities to implement them. Therefore the connection between marginalized communities, and social venture capital investors needs to be strengthened. That should be supported by decision makers in development organizations in partnership with social venture capital investors' that consider engagement to mobilize the untapped human resources of the ultra poor.

Clas Wihlborg

Professor, Chapman University

Enabling legal reform for financial market inclusion

Background. A number of institutional and policy innovations have contributed to increasing the reach of financial markets in the new millennium. Micro-finance institutions stand out as successful in reaching relatively poor citizens in many countries. Other proposed and, to some degree, implemented, reforms that potentially increase the reach of credit markets refer to pension systems, insolvency procedures for firms and attempts to reduce corruption in the judicial system. Countries in Central and Eastern Europe have implemented far-reaching property rights reforms.

In spite of innovations, even relatively small amounts of credit are out of reach for a large share of small businesses and potential entrepreneurs as well as of their potential customers. They must rely on cash transactions to a large extent. Advance payments and supplier credit is restricted to customers and suppliers who know they can trust a particular business man. The lack of credit implies that the firms can not extend much credit to potential customers even if they are considered trustworthy. Altogether, the lack of working capital limits the scale and scope of business activity, and hinders expansion.

"Enabling legal reforms" expand the scope of financial contracts to parties that must not rely entirely on trust based on personal knowledge and social pressure. Large scale financial activity requires that anonymous lenders and borrowers can transact with reasonable certainty about contractual performance. Banks rely traditionally on collateral pledged by borrowers at the time of contracting and/or ability to claim assets of non-performing borrowers. Both ex ante commitments of borrowers in the form of pledge of collateral and ex post claims on general assets of borrowers require:

1. Well defined and transferable property rights to assets.
2. Fair and speedy enforcement of contractual terms in case of breach of contracts and disputes.

Hernandez de Soto has suggested that the millions of people with no or little wealth, who are squatting on pieces of public land should be given registered and transferable property rights to the pieces of land they are using. Even if each piece of land is small, it could be used as collateral for, for example, working capital loans of a small entrepreneur. For this to be possible the property ownership must be clearly defined and registered in order for the lender to be certain that the property can be claimed if the borrower does not perform. The borrower must also be certain that the claim on the property will be enforced with reasonable speed.

Substantial enforcement, fairness and incentive problems associated with the de Soto proposal will be discussed below. Nevertheless, the de Soto proposal provides a starting point to build on for enabling financial market reform:

Proposal: Part 1. Seek ways to register secure title (ownership rights) to land to allow people de facto possessing and using even small pieces of land to obtain title to this land. Once title to land is granted the owner must be able to transfer the title and enter into contracts as owner.

Enforcement of contracts is weak, uncertain or extremely time consuming in many developing countries. For this reason the above proposal should be complemented with reform of the judicial system in such a way that even small ownership claims, conflicts about ownership rights, small credit contracts based on collateral, as well as small credit contracts more generally can be resolved and enforced with predictability and speed. Since the legal systems in many countries are quite weak it may be necessary to develop a separate court system to deal with relatively small contractual disputes:

Proposal: Part 2. Set up special “small claims courts” (as in the US and the UK) with easy access and speedy, clear procedures administered separately from the existing legal system. The courts would help enforce contracts for small amounts and settle contractual conflicts up to a certain maximum amount whether the contracts are written or not. Judges may have to be selected by specific skill and personal criteria in order to make the system free from corruption and influences from politics.

A “small” amount can be large relative to the total wealth of an individual even if it is small relative to the size of most contracts handled by the existing legal system. For example, a US$500 loan can be small for a bank but extremely important for the individual borrower.

As noted, there are a number of fairness and incentive problems associated with the implementation of the first proposal. A property rights reform must be implemented in such away that these problems are minimized.

One fairness issue is how to deal with squatters illegally in possession of certain types of public land, for example, land near or on garbage disposals, rail-yards or sidewalks. There are also some poor people with no land at all in their possession. One solution to these problems would be to issue vouchers to all landless and to give people priority to buy all or some of the land they are in possession of. Of course, all publicly owned land potentially available for the landless would have to be parceled up in small lots and registered before people would be able to use the vouchers to buy a piece of land. Thus, the registration of land should be separated from the assignment of ownership.

The incentive problem associated with giving title to land in possession by individuals is that “race for possession” could start as soon as the reform is announced. Such a race could easily turn very ugly. Even after the implementation of a reform race for possession could continue if people expect another round of ownership transfer. The voucher system could be designed in such a way that “race for possession” can be avoided. The first proposal could accordingly be modified in the following way.

Proposal: Part 3. Issue vouchers to the landless with rights to purchase small pieces of public land that already has been sub-divided and registered in a land registry. Valuation of land and vouchers could be based on outsiders’ estimate of the total value of the land to be allocated or auctions could be held with pricing in terms of number of vouchers. In order to give priority to current users of a piece of land, this user need not bid on that particular piece of land but have the right to buy the land at the highest bid from others.