

Governance, Growth and Poverty Reduction

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Summary: Poverty reduction is arithmetically a function of economic growth rates and income distribution and changes in income distribution. Governance can impact both growth and income distribution in ways not fully understood. The dominant market-enhancing governance paradigm seeks to enhance the efficiency of markets through 'good governance' reforms, ostensibly to trigger or sustain growth. On the distribution side, good governance reforms often have a 'pro-poor' component to improve governance capabilities to enhance the scale and efficiency of service delivery to the poor. The limitations of the good governance approach to enhancing growth are well known. Neither the theory nor evidence strongly support the plausibility of improving distributive outcomes for the poor through the pro-poor parts of the good governance agenda. Alternative governance approaches for addressing poverty are contrasted favourably with the currently dominant paradigm.

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Growth, Distribution and Poverty Reduction: The Issues

The debate about policy and poverty reduction touches on three interrelated issues: the measurement of poverty, the arithmetic decomposition of poverty reduction into growth and distribution effects, and the causal relationships between growth, distribution and policy variables affecting them. The appropriateness and accuracy of measures of poverty have come under repeated scrutiny. There are wide variations in the measures, and small changes in underlying measurement techniques can have significant effects on measured poverty. These measurement problems make it difficult enough to identify trends, and certainly make it very difficult to test complex causal relationships with satisfactory degrees of confidence. On the other hand, the arithmetic relationship among mean incomes, income distribution and poverty is relatively simple, and can be used to decompose poverty reduction into income growth and distribution components. But these decompositions do not directly tell us much about the *causal* relationships among growth, distribution and the variables that jointly affect them, which have been the subject of considerable debate. This paper focuses primarily on these causal links, looking particularly at the likely causal relationships between good governance reforms and poverty reduction, operating through effects of governance reforms on distribution. But we begin by outlining the key measurement and arithmetic issues underlying the analysis.

Measurement Issues

Poverty is typically measured by the headcount measure, the proportion of the population below a commonly agreed poverty line. In recent years, the \$1 a day line used by the World Bank has achieved wide usage. The first set of poverty measures using this line was published in the *World Development Report 1990* for 22 countries for 1985, using 1985 PPP to convert the dollar a day line into local currencies. In 1993, PPP data were substantially revised and improved, and using these numbers, a new poverty line was chosen from the median of the ten lowest national poverty lines which gave a figure of \$1.08 at 1993 PPP. This figure (still described as the dollar a day line) was the basis of subsequent World Bank estimates of national and global poverty till the international poverty line was further updated to \$1.25 in 2005 PPP prices. The new 'dollar-a-day' line emerged as the mean of the national poverty lines of the fifteen poorest countries converted into 2005 PPP dollars. Clearly, changes in the dollar-a-day line were not made to ensure that a similar basket of nutritional or other characteristics could be purchased by those PPP dollars over the years. Rather the particular level of the line was derived as the mean or median of an arbitrarily chosen set of national poverty lines converted into PPP dollars. As a result, it is not clear that the Bank's headcount poverty measures over time identify the proportion of population below a fixed absolute consumption level (Reddy and Pogge 2005; Ravallion 2008a, 2008b).

A further problem with these standard World Bank poverty measures is that they are very sensitive to estimates, both of the conversion rate of the PPP dollar poverty line into local currency using the PPP conversion rate for the benchmark year, and then the conversion of this local currency poverty line for the benchmark year into a poverty line for the current year using consumer price indices. Changes in the estimates of the PPP conversion rate or the consumer price index can significantly alter estimates of poverty. Updating price data explains some of the significant changes in the estimates of global poverty that the World Bank has been forced to

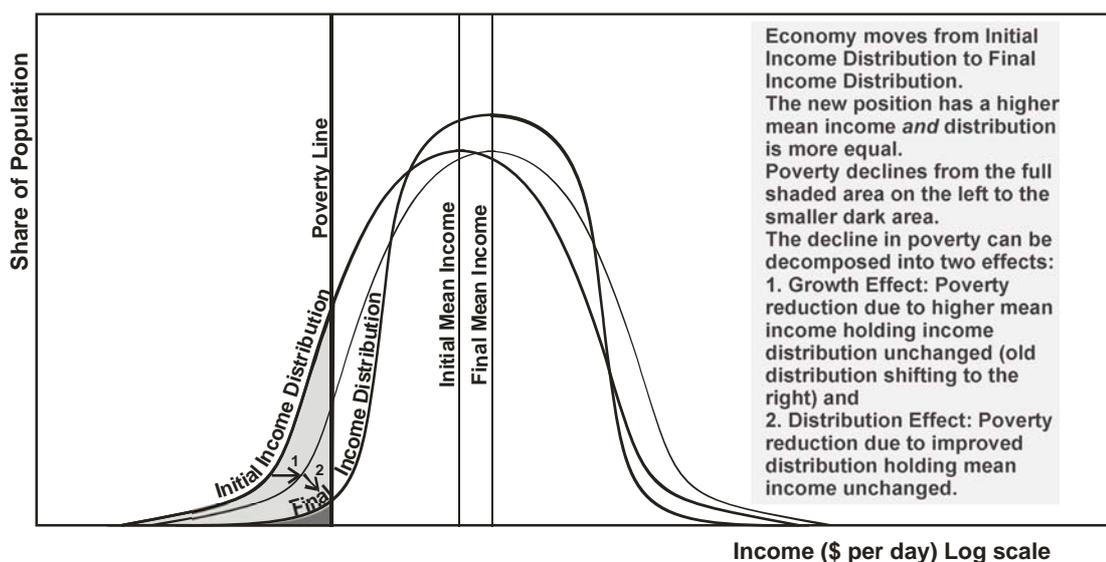
announce. For instance, the revision of PPP estimates in 2005 and the revision of the poverty line from \$1.08 at 1993 PPP dollars to \$1.25 at 2005 PPP dollars resulted in the estimate of the proportion of global population living in poverty increasing from 17.2 per cent to 25.7 per cent, an obviously massive change in the numbers (Chen and Ravallion 2008: Table 4).

Finally, computing the conventional headcount poverty measure requires the use of national income distribution statistics typically derived from expenditure or income surveys, and these vary significantly in quality across countries and over time within countries. These data issues need to be kept in mind when we comment on changes in poverty in developing countries based on these numbers. Even so, the headcount ratio is the simplest and crudest of the measures of poverty. It ignores the distribution of poverty under the line. Other measures of poverty that take the distribution of poverty below the poverty line into account are even more difficult to estimate (Datt and Ravallion 1992). These significant data issues mean that we are not in a position to trace the effects of policy with any precision. The data are at best able to indicate very broad trends, and even that with significant qualifications.

The Arithmetic of Growth, Distribution and Poverty Reduction

Poverty reduction is arithmetically related to growth and changes in income distribution. The density function describing the share of the population that receives each per capita income provides all the information required to estimate any measure of poverty. That density function, in turn, can be described by its mean and the shape of the distribution around that mean. The headcount measure of poverty is simply the area to the left of the poverty line under the density function shown in Figure 1 adapted from Bourguignon (2004: Figure 1). If we look at the initial distribution of income in Figure 1, the proportion of the population below the poverty line is specified by the shaded area in yellow.

Figure 1. Decomposition of Poverty Reduction into Growth and Distribution Effects



Changes in the level of poverty can be related to changes in per capita incomes (a shift of the density function usually to the right) and changes in the distribution of this

income (a change in the shape of the density function). If the distribution of income stays constant, income must have changed for all income groups at the same rate. In Figure 1, the logarithmic horizontal axis ensures that a rightward shift of the density function will entail the same percentage change in the incomes of all groups. Moving the density function to the right therefore shows a pure growth effect with no change in the distribution of relative incomes. If distribution worsens (incomes rise faster for richer groups), poverty reduction will be slower because incomes of poorer groups will be rising at a rate lower than the average (the area under the curve at the bottom will increase). In contrast, if distribution improves, poverty reduction will be faster because the incomes of poorer groups will be rising faster than the average, so that not only is the density function moving to the right, it is also moving downwards at the bottom end (Datt and Ravallion 1992; Kakwani 1993; Bourguignon 2004).

Figure 1 shows that when both mean incomes and the distribution of relative incomes change, the overall change in poverty can be decomposed into a growth component (the change in poverty, holding distribution constant) and a distribution component (the change in poverty, holding mean income constant). In the example in Figure 1, per capita incomes are increasing *and* distribution is becoming more equal. The decomposition shown in Figure 1 allocates the entire reduction in poverty to a growth effect and a redistribution effect, but this neatness is achieved because the decomposition is done sequentially. A different sequence may suggest a slightly different breakdown if the redistribution effect was identified first and the growth effect second. A mathematically correct decomposition would calculate the growth effect with reference to a determinate reference distribution and the redistribution effect with reference to a determinate reference mean income. In this technically correct method, the contributions of growth and redistribution do not depend on the sequence of decomposition, but the overall decomposition will usually entail a small residual which cannot be uniquely attributed to either growth or redistribution (Datt and Ravallion 1992: 276-279).

The decomposition of poverty into growth and redistribution provides a number of arithmetic insights that are not in dispute. First, poverty reduction will be faster if the growth of per capita income is higher, and/or if income distribution is improving. Secondly, since income distribution cannot keep improving and has, in any case, an arithmetic upper bound when all incomes become equal, the long-term driver of poverty reduction must be growth. In most countries, the feasible upper bound on distribution is likely to be arrived at much before full equality. But thirdly, income distribution in most developing countries is so far away from equality that significant poverty reduction is arithmetically possible for a while if distribution improves. Fourthly, for any given growth rate of per capita income, poverty reduction will be faster if incomes are more equally distributed to begin with. These arithmetic facts are not in dispute, but they do not help to resolve the intense disputes about *causality* and the appropriate content of poverty reducing policies.

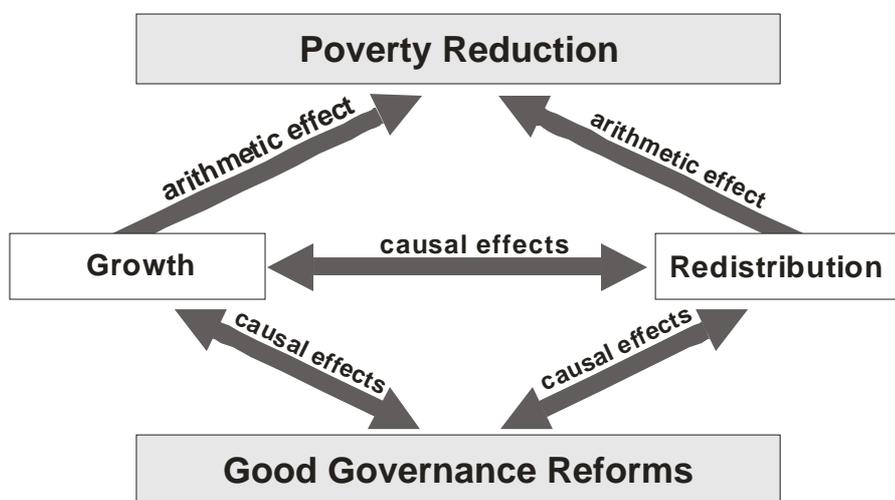
Causal Links between Growth, Redistribution and Governance

A wide range of contradictory causal relationships have been suggested between growth and redistribution. The inconclusive empirical testing of these possible hypotheses suggests that the relevant relationships may vary significantly across countries, regions and periods. The causal relationships relevant for particular countries are nevertheless important, because it may be that higher growth may

require policies that slow down or reverse improvements in distribution, or it may be that higher growth requires improvements in income distribution. The causal relationships between distribution and growth relevant for a particular country have significant implications for poverty reduction. For instance, if improvements in distribution have a negative effect on growth, an excessive focus on redistribution may have negative growth effects that could more than offset the positive redistribution effects for poverty reduction.

The causality between growth and redistribution can also run in both directions. Growth may, in turn, have causal effects on distribution that may be positive or negative, and again, there are obvious implications for poverty reduction. Finally, both growth and distribution are likely to be responsive to policy and these policies can be judged in terms of their impact on growth and redistribution. The optimal policy mix would depend on the effective relationships between growth and distribution. For instance, a specific policy to achieve higher growth may not be recommended if it has very adverse implications for distribution if we are concerned about immediate poverty impacts. In turn, both growth and income distribution can determine the effectiveness of specific policies, because the political feasibility of implementing particular policies may depend on the environment of growth and distribution. As we are particularly concerned with governance reform, Figure 2 summarizes these interdependencies among growth, redistribution and policy with reference to strategies of implementing good governance reforms.

Figure 2. Causal links among governance, growth and redistribution



Growth-Redistribution Causal Linkages

The two-way horizontal arrow in Figure 2 shows the critical and possibly two-way causal relationships between growth and distribution that have been the subject of considerable debate. Many types of interactions between growth and distribution are theoretically possible. An important link operates through the savings-investment effect. But as Figure 3 summarizes, the savings-investment link between distribution and growth may take radically different signs depending on often implicit assumptions about initial conditions and the presence or absence of other necessary institutional and economic conditions. The classical position on the direction and sign

of the savings-investment effect was articulated by Kaldor (1957), drawing on the classical political economy insight that growth in capitalist economies is driven by the investment of profits. As profits are the incomes of capitalists, the higher investments that drive growth may be associated with a more unequal distribution of income.

This argument can be interpreted to imply that greater equality would have a negative effect on growth. What is often not clearly articulated is that even if higher profits were associated with greater inequality, this would only imply higher growth rates if other factors were conducive to sustaining high levels of investment. There is no point having high levels of profits if expectations of future profitability are weak and investments in potential growth sectors do not take place. So we should not be surprised if we do not find an overall relationship between inequality and growth in cross-sectional analysis looking at all countries together. However, for particular countries where complementary conditions were conducive, the Kaldor effect may be plausible.

Figure 3. Theoretical Linkages between Growth and Redistribution



The savings-investment effect can also directly suggest the opposite relationship between equality and growth. Amartya Sen's capabilities approach to development can be interpreted as saying that greater equality would be good for, or at least compatible with, poverty-reducing growth (Sen 1999). Redistribution to the poor would allow higher investments in areas like health and education that enhance the capabilities of the poor to participate in growth. Variants of this argument point out that a failure in capital markets can prevent the poor from accessing capital if their initial endowments of assets are too low. These arguments are also theoretically plausible, but equally, there is likely to be little point in building capabilities for the poor, in the way Sen's argument suggests, if employment opportunities for the somewhat educated poor do not also emerge. The poor are unlikely to be able to create globally competitive employment opportunities for themselves simply because they have some basic capabilities, given the scale of investments required to achieve global competitiveness. Thus, it is not surprising that some developing countries and regions with above average education underperform in terms of growth because of poor employment generation. These economies often become exporters of skilled labour rather than high growth economies. The cases of Kerala within India and of the Philippines in South East Asia are particularly relevant (ADB 2007: 317-38).

A second linkage between distribution and growth operates through the mechanism of political redistribution, shown by the arrow growing through the lower box in Figure

3. Examples are Alesina and Rodrik (1994) as well as Persson and Tabellini (1994) who suggest that inequality would have a negative effect on growth by creating pressures for taxation and redistribution. Attempts by political organizations to achieve this redistribution, in turn, have a dampening effect on growth. Curiously, the reason that inequality leads to low growth in these models is that political attempts to *improve* distribution in societies with initially poor distribution result in adverse effects for investment and growth!

The political economy behind many of these models is implausibly simplistic. It is not possible to say much that is useful even about the sign of the relationship between initial distribution and political responses to it without a fuller picture of the political structure of a country, its level of development, the structure of its economy and so on. For instance, a society that is very unequal may have fewer distributive conflicts if the poor are really poor and disorganized compared to one that was more equal but had powerful intermediate classes who could lead the mobilization against the rich. Similarly, whether redistributive demands lead to conflict and low investments would depend on the political responses of the rich, their productive capability of meeting redistributive demands and the agenda of the political leadership that would determine what is done with the redistributed incomes.

Finally, as Figure 3 shows, growth can directly affect distribution as suggested by Kuznets (Kuznets 1955). Kuznets suggested that as the capitalist or modern sector in developing countries grew, income inequality would initially worsen and then eventually improve, implying an inverse-U shaped relationship between per capita income and inequality. His argument depended on the possibility that mean income in agriculture was lower and distribution is relatively more equal than in the emerging industrial sector. As labour moved from agriculture to industry, income distribution would initially worsen despite overall mean incomes growing. This argument suggested that growth in poor countries could lead to greater inequality, but growth in middle income or richer countries could lead to improvements in equality. However, even in poor countries, poverty would be unlikely to increase as a result of growth because for the economy as a whole, the positive growth effect would be likely to at least balance, if not outweigh, the negative redistribution effect. The Kuznets effect is to be distinguished from the Kaldor effect, where growth may require an increase in savings, and therefore, a prior worsening of income, and may theoretically result in increases in poverty for a time.

Not surprisingly, given the number of plausible theoretical relationships between growth and distribution with opposite signs and directions of causality, the empirical evidence is indeterminate. Each of these plausible mechanisms depends on implicit institutional, political and economic conditions being appropriate. In cross section studies where country-specific conditions are almost impossible to fully account for, the overall relationships observed are likely to be either indeterminate or spurious. Alesina and Rodrik (1994) as well as Persson and Tabellini (1994) provide some empirical support for the hypotheses that higher initial inequality results in lower growth. On the other hand, Forbes (2000), using a better data set on income inequality and using panel data to limit the impact of regional effects, finds a positive relationship between inequality and growth at the level of countries. This suggests that when we look at individual countries, periods of rising inequality are associated

with subsequent growth accelerations, consistent with the Kaldorian relationship between inequality and growth.

The panel data analysis suggests that the negative relationship between inequality and growth in some cross section regressions may have been capturing regional effects because many low growth regions happened to have relatively poor income distribution. A positive relationship between inequality and growth along the lines of Forbes is also reported by Li and Zou (1998). In their test of Kuznets using panel data, Deininger and Squire (1998) find a very weak relationship between growth and inequality. Since a relationship does exist in cross-sectional data, they suggest that the Kuznets relationship could also be picking up regional effects. None of these studies attempt to test these relationships using more sophisticated theories which identify the specific conditions under which relationships of a particular sign and direction of causality may hold. One reason for this is the thinness of the data and the very limited time periods over which distribution data are available for developing countries.

Good Governance as Market-enhancing Governance

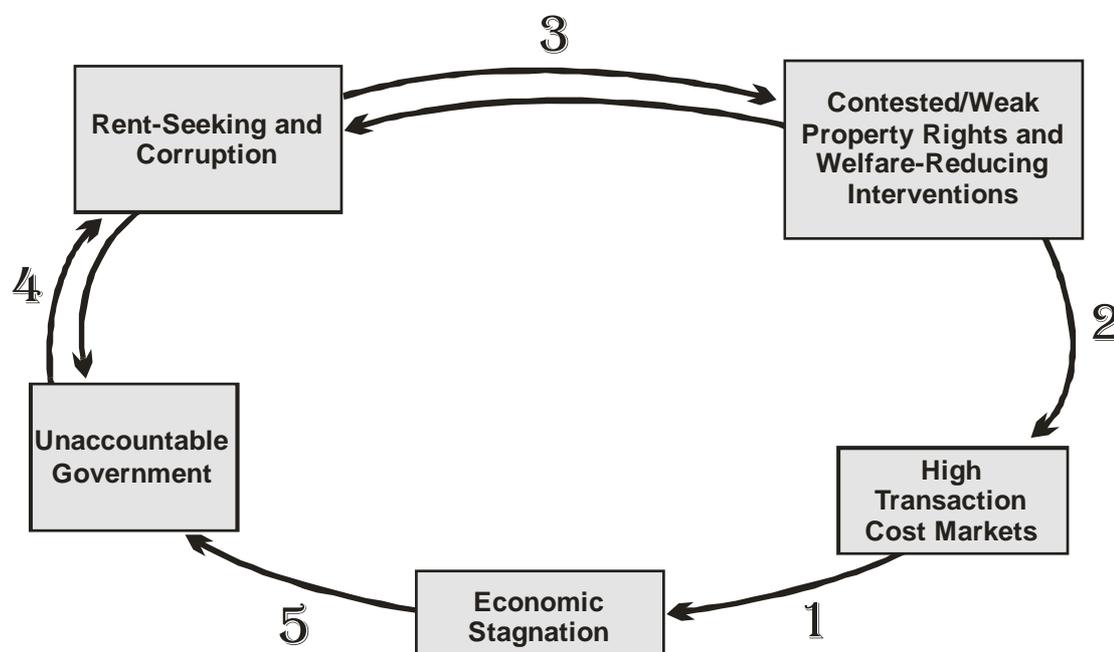
Keeping these fundamental questions about the relationship between growth, distribution and poverty in mind, we can look at the important policy area of governance reform to see how these reforms may affect poverty. We can examine this by looking at the possible effects of governance reforms on growth and distribution. Much of the emphasis of good governance reforms has focused on the likely effect of these reforms on growth. The anomalous nature of good governance on growth has been examined elsewhere (Khan 2007). Here, we will focus on the likely effects of good governance reforms on poverty through possible effects on distribution. But first, we need to briefly describe what good governance reforms refer to.

Governance reforms refer to strengthening state capabilities to enforce institutional rules that are important for economic and social development. The dominant 'good governance' paradigm identifies a series of capabilities that, it argues, are *necessary* governance capabilities for a market-friendly state. These include, in particular, the capabilities to protect stable property rights, enforce the rule of law, effectively implement anti-corruption policies and achieve government accountability. Many of these capabilities are clearly desirable as they help to achieve conditions that are desirable. But in the good governance framework, these capabilities are not just *desirable for achieving some of the goals of development*. Rather, good governance capabilities are identified as *preconditions for development* because they ensure that markets will be efficient and less subject to market failures (Khan 2007).

The new consensus draws on a particular reading of the New Institutional Economics to derive these conclusions. A core proposition is that efficient markets are achievable in developing countries, and efficient markets will drive development. The inefficiency of markets in developing countries is the source of market failures that constrain development. These inefficiencies are due to high transaction costs in developing country markets, which are, in turn, due to poorly protected property rights and welfare-reducing rent-creating interventions. Unstable property rights and welfare-reducing interventions, in turn, persist because of corruption and rent seeking because some individuals and groups benefit from these instabilities and interventions. And finally, damaging rent seeking and corruption continue because of

weak accountability and a lack of effective democracy, which allow a minority to benefit at the expense of the majority. The links in the argument are summarized in Figure 4.

Figure 4. Causal Links in the Good Governance Argument

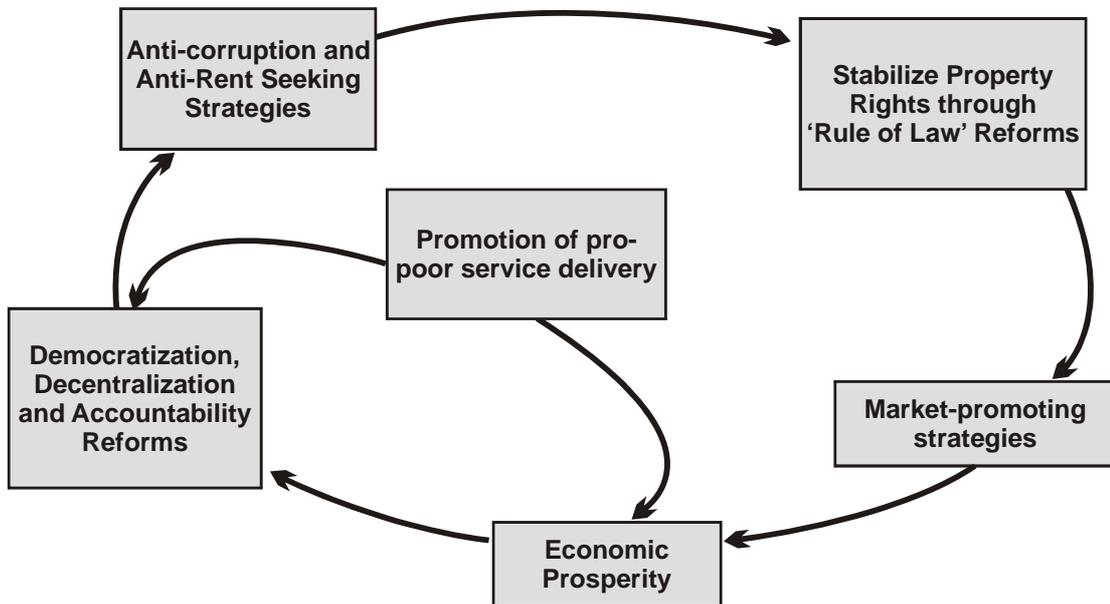


Source: Khan (2008: Table 4)

The good governance agenda therefore aims to reduce the market transaction costs which are theoretically the source of important market failures. The expectation is that strengthening the requisite capabilities will reduce market transaction costs, which in turn will drive development. This is why in Khan (2007) and elsewhere, we described the ‘good governance’ agenda as one of *market-enhancing governance*. To the standard liberalization strategies which have been the core component of the international development consensus, the good governance agenda adds a number of simultaneous reform priorities. Most of these follow directly from the links identified in Figure 4 and are shown in Figure 5.

States have to achieve capabilities for protecting property rights and contracts using the rule of law. These require capabilities for fighting corruption and rent seeking, which, in turn, have to be bolstered by reforms promoting democratization, decentralization and accountability. The final component often added to the package by development agencies is the promotion of pro-poor service delivery as a way of mobilizing the poor who are the majority or close to the majority in poor countries. If this group can be mobilized to hold the state to account by ensuring that the state delivers to them, then the accountability essential in this framework can be kick-started. The importance of pro-poor service delivery in this governance approach is therefore not simply the direct effect on poverty (initially funded mainly by external agencies), but primarily to establish the virtuous cycle of governance which, in theory, will sustain market-led growth.

Figure 5. The Good Governance Policy Agenda



Source: Khan (2008: Table 5)

Good governance and growth

We have argued elsewhere that the expectation that implementing good governance reforms in developing countries will drive growth is unlikely to be met. This is not because the theory is implausible, but because there are structural and fiscal constraints that prevent the achievement of significant improvements in the good governance capabilities shown in Figure 5 in poor countries. As a result, the achievement of lower market failures through this route is likely to be very limited. Indeed, when we compare high-growth and low-growth developing countries, we do not find significant differences in their scores on good governance (Khan 2004, 2008). High-growth developing countries do not, in general, have better governance compared to other developing countries in terms of their good governance capabilities. But case study evidence suggests that developing countries that have sustained high growth over long periods did have significant governance capabilities to identify and address significant market failures.

These observations suggest that developing countries that focus exclusively on good governance reforms are not likely to achieve significant improvements in their growth rates as a result. Indeed, they are unlikely even to achieve significant improvements in good governance across the board given the structural and fiscal constraints that we have referred to. The achievement of good governance goals – like the stabilization of property rights, the achievement of good rule of law or the significant reduction of corruption – require fiscal capabilities not available in the typical developing country. In this context, market failures are likely to remain significant and serious, and are unlikely to be significantly reduced by good governance reforms. Developing countries therefore also need to focus on alternative governance capabilities that enable them to directly address market failures. We have elsewhere described this as a *growth-enhancing governance* agenda which focuses on developing governance

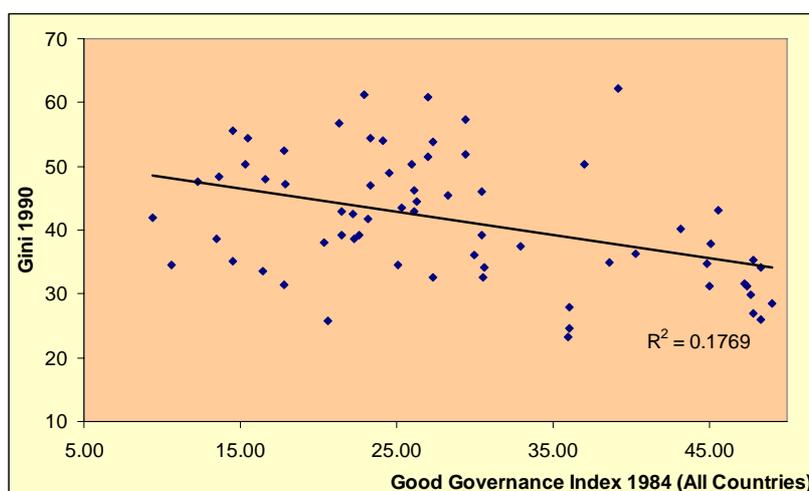
capabilities appropriate for directly addressing a limited number of important market failures in particular developing countries (Khan 2007, 2008).

Good governance and distribution

While the impact of good governance on growth is unclear at best (Khan 2004, 2007, 2008), it is possible that good governance reforms may have an impact on poverty reduction by improving income distribution in poor countries. If so, the implementation of good governance capabilities may have a positive impact on poverty in poor countries. This is primarily likely to happen through the pro-poor service delivery aspect of good governance reforms shown in Figure 5, but also through the protection of property rights and the rule of law, through anti-corruption policies and democratization, all of which could, in theory, allow the poor to protect their rights better, demand better services from the state, and ensure that a greater part of the public goods that they are entitled to are in fact delivered. If so, even if good governance reforms had an anomalous effect on growth, it may have an effect on poverty by improving distribution.

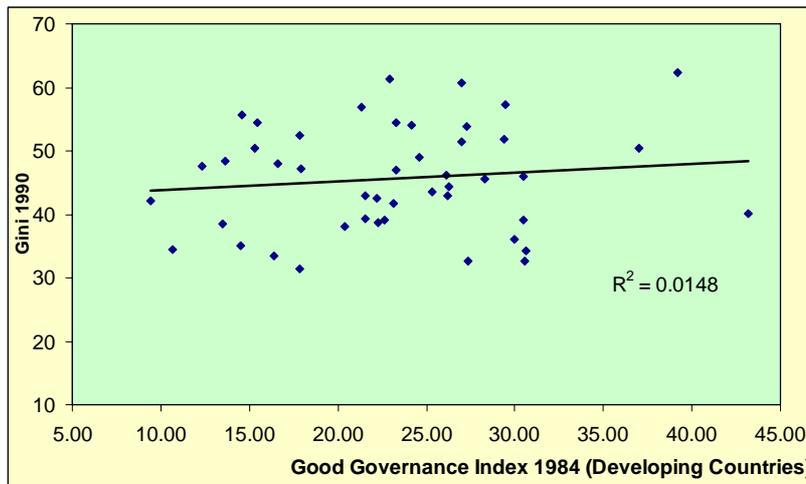
The quality of the data available on distribution and the short time-periods over which indices of good governance are available do not allow us to do much more than look at some broad features of the possible relationship. To begin with, we need to have data for governance at some time in the past and data on distribution in a subsequent period so we can ask if countries with better scores on good governance ended up with better income distribution compared to other countries. The earliest cross-country data on governance comes from the IRIS-3 (2000) project based on surveys and expert opinions. This provides a series of governance indices beginning in 1984 on corruption, rule of law, bureaucratic quality, contract repudiation and expropriation, which can be blended to give a combined index of good governance on a scale from 0 to 50. The most comprehensive data on distribution for the late 1980s and early 1990s comes from Deininger and Squire (1996) who collate the best available Gini measures of income distribution for a set of countries.

Figure 6. Good Governance and Distribution, 1990 (all countries)



Source: IRIS-3 (2000) and Deininger and Squire (1996)

Figure 7. Good Governance and Distribution, 1990 (developing countries)



Source: IRIS-3 (2000) and Deininger and Squire (1996)

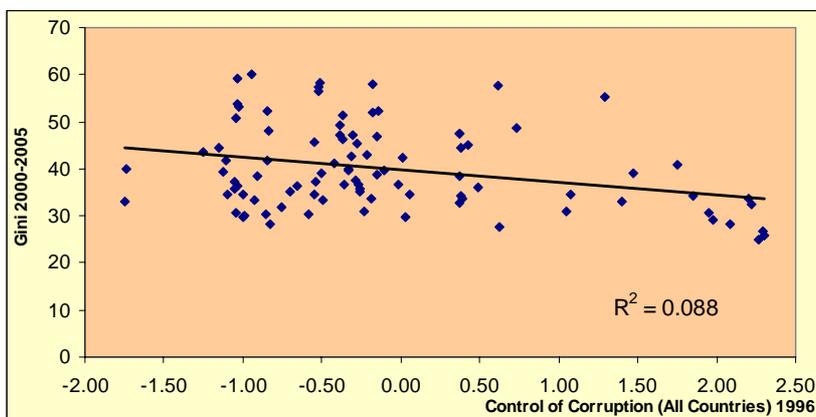
Figure 6 looks at the relationship between good governance scores and income distribution in the 1980s using these figures for the full set of countries for which data are available. There is no obvious pattern in the scatter diagram, but a weak negative relationship appears when we fit a line, suggesting that countries with better governance may have had a tendency to have better income distribution. However, this disappears entirely if we exclude advanced countries from the data, as shown in Figure 7. Although this fit is very poor, the fitted line now has a positive slope, suggesting that developing countries with better governance tended to have worse income distribution than the others. But, in fact, the scatter suggests the absence of any obvious relationship.

For the 1990s, we have governance indicators from 1996 onwards in the Worldwide Governance Indicators collated by the World Bank (World Bank 2008b). These are indicators for a number of good governance variables compiled from internationally available indicators. The indicators for each aspect of governance are normalized to have a mean of zero for each variable for each year, so they cannot be blended together to provide a composite good governance indicator (or one easily compared across years) for that country. We have used the three indicators most directly related to the good governance agenda: the rule of law, control of corruption, and voice and accountability. The subsequent income distribution data used was the average of the Gini indices for countries available from the World Bank's World Development Indicators for 2000 to 2005 (World Bank 2008a).

We used only those countries for which all three governance indicators were available for 1996 and for which at least one Gini observation was available for 2000-2005. Where more than one observation was available, we used the average. The relationship between these governance indicators and their subsequent distribution, for all countries for which all the relevant data were available, is shown in Figures 8 to 13. As with the 1980s, the data for the 1990s show that while there is, at best, a very weak positive relationship when we pool all countries together (better governance leads to more equal income distribution), the relationship entirely disappears or takes the wrong slope when we look at developing countries separately.

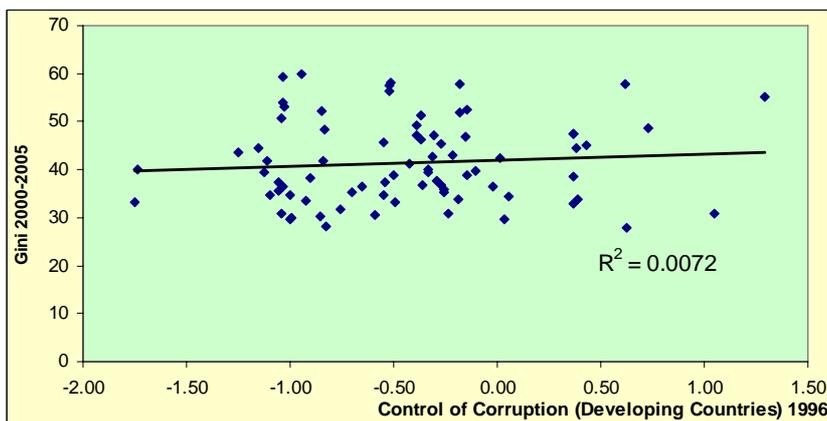
The danger of pooling all countries together is that we may be picking up arbitrary regional effects or structural differences between rich and poor countries along the lines of a possible Kuznets effect (Bourguignon 2004: 12-13). If the group of rich countries has, for whatever reason, better income distribution *and* better good governance scores for *unrelated* reasons, the pooled data will show a positive, but spurious relationship between good governance and better distribution. By separating developing from developed countries, we can reduce some of these problems, and when we do so, the relationship between good governance scores and distribution either disappears or takes the wrong sign.

Figure 8. Control of Corruption and Distribution, 2005 (all countries)



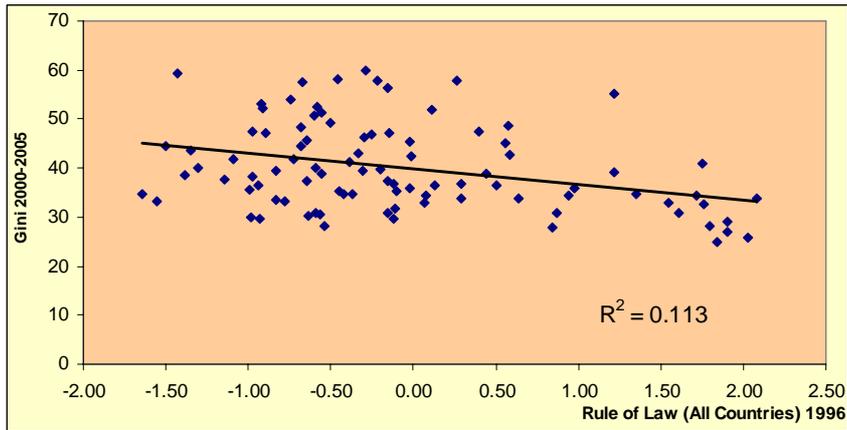
Source: (World Bank 2008a, 2008b)

Figure 9. Control of Corruption and Distribution, 2005 (developing countries)



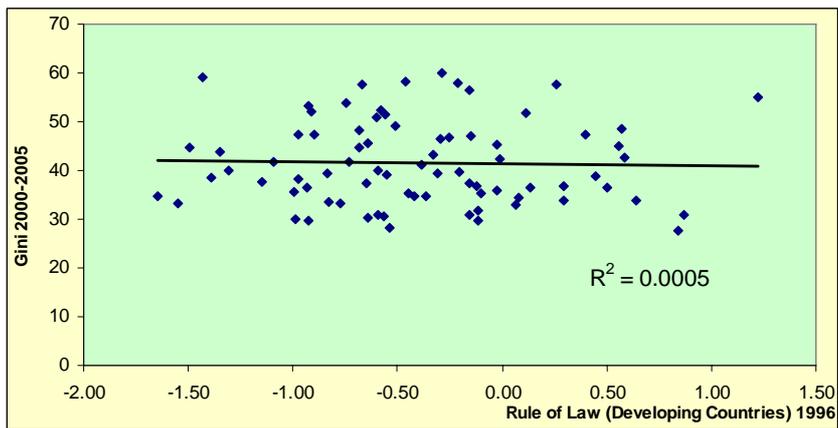
Source: (World Bank 2008a, 2008b)

Figure 10. Rule of Law and Distribution, 2005 (all countries)



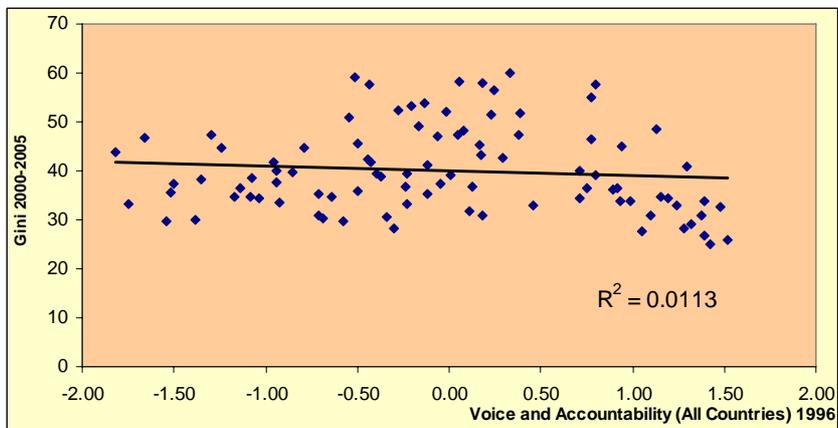
Source: (World Bank 2008a, 2008b)

Figure 11. Rule of Law and Distribution, 2005 (developing countries)



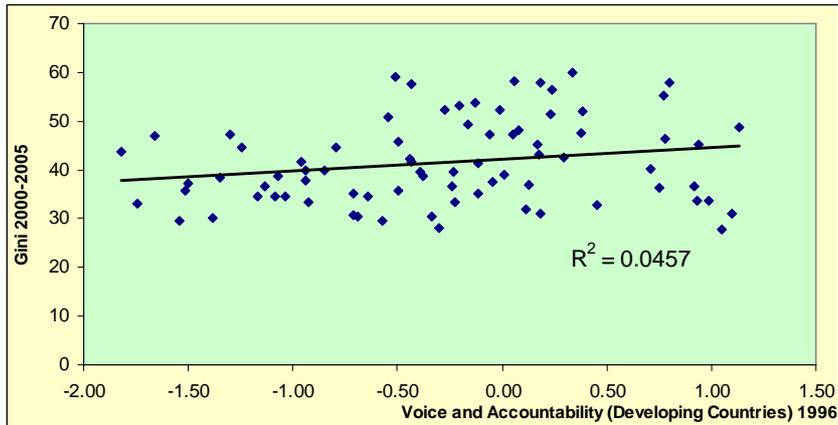
Source: (World Bank 2008a, 2008b)

Figure 12. Voice and Accountability and Distribution, 2005 (all countries)



Source: (World Bank 2008a, 2008b)

Figure 13. Voice and Accountability and Distribution, 2005 (developing countries)



Source: (World Bank 2008a, 2008b)

Missing from the empirical review above is an assessment of the effects of pro-poor spending programmes on distribution. We know that support for pro-poor spending has been an important part of aid-supported good governance policy packages (Figure 5), but there are no statistical indicators available for the extent or type of pro-poor spending programmes across developing countries. Pro-poor spending will have an obvious arithmetic effect on distribution, and therefore on poverty. But the immediate arithmetic effects of pro-poor spending programmes on distribution and poverty reduction are less important than the possible triggering effect they may have in changing the state-society relationship, as outlined in Figure 5. As pro-poor spending programmes are typically funded by aid, the arithmetic effect on its own is not sustainable because aid is not forever. The effect is only likely to be sustainable if there is a lasting impact on accountability, and if accountability, in turn, results in a sustainable improvement in income distribution, for instance through a sustainable reallocation of public spending towards pro-poor public goods. We do not know if pro-poor aid programmes have resulted in sustainable improvements in accountability, but there does not seem to be any obvious relationship between the accountability scores of developing countries and their overall Gini indices.

Given the type of data available to us, and the very limited time periods for which data are available, all we can say from the scatter points is that strong relationships between good governance capabilities and improvements in income distribution do not appear to exist. More rigorous testing, using time series or panel data approaches, is required to examine if improvements in good governance in particular countries resulted in improvements in distribution in that country over time, but data for a much longer period would be required to investigate these possibilities further. For the 2000-2005 period income distribution data were available in many cases only for a single year. In the meantime, we can examine the possible theoretical linkages between governance capabilities and distribution, and in particular, the possible significance of the package of capabilities and priorities that the good governance approach identifies for distribution in developing countries.

Good Governance and Distribution: Theoretical Linkages

The linkage between the implementation of good governance reforms in poor countries and its effects on poverty through distribution depends on the types of implicit assumptions that we make about a series of background conditions. We combine the key policy features of the good governance reform package outlined in Figure 5 with the causal linkages between distribution and growth outlined in Figure 3 to show that the effects of good governance reforms depend on an underlying set of implicit assumptions. Making some of these assumptions explicit may help us to assess the plausibility of the claims made for poverty reduction through good governance reforms in specific country contexts.

Figure 14. Optimistic Scenario: Good Governance and Pro-Poor Distribution



Figure 14 shows the optimistic linkages that could justify good governance reforms as a way of achieving poverty reduction. In this optimistic scenario the pro-poor spending part of the package has a positive effect on investment in human capital and on the access of the poor to potential investment resources. The growth-enhancing effects of these investments depend on the presence of employment opportunities that are simultaneously created for the new potential workers with better human capital, or less realistically, on the poor being able to borrow enough to create viable employment opportunities for themselves. This part of the story is therefore closely dependent on whether good governance reforms are likely to simultaneously accelerate the creation of employment opportunities through growth effects for the emerging capitalist sector.

The growth effects of the good governance reform agenda are theoretically plausible, but unlikely to be strong. We have discussed elsewhere that structural weaknesses of poor countries are likely to prevent them from significantly implementing good governance reforms. At the same time, growth in the modern sector is likely to be constrained by significant market failures unlikely to be addressed by the limited improvements in market efficiency achieved through good governance reforms (Khan 2007, 2008). If the growth of employment opportunities does not materialize, then this aspect of pro-poor spending will effectively have been a limited period of enhanced consumption for the poor. But in fact, since services like education and health for the poor will have been primarily provided by non-poor service providers, the main beneficiaries of pro-poor spending are likely to be the non-poor, with the poor acquiring some skills or consuming better health care for a while. Sustainable improvements in the incomes of the poor and therefore the effects on poverty through

growth will only materialize if these investments in human capital are supplemented with a growth in job opportunities.

There is however a second and more direct effect on distribution and poverty through the effect of good governance reforms and support for pro-poor spending on the mobilization of the poor to hold governments to account. This is shown in the lower fork in Figure 14. The provision of pro-poor public goods through the state (initially funded by aid) together with good governance reforms that encourage accountability, attack corruption and strengthen the rule of law could induce the mobilization of the poor to demand effective delivery of what has been promised to them by law. If the response of the poor is to form sustainable and viable organizations (such as political parties or citizens groups) to ensure effective service delivery, these could continue to operate to hold the state to account over time. If this happens, the redistributive effect could be permanent, not just limited to the period for which aid is available. This is indeed the chain of causation suggested in the policy linkages of the good governance reform package shown in Figure 5.

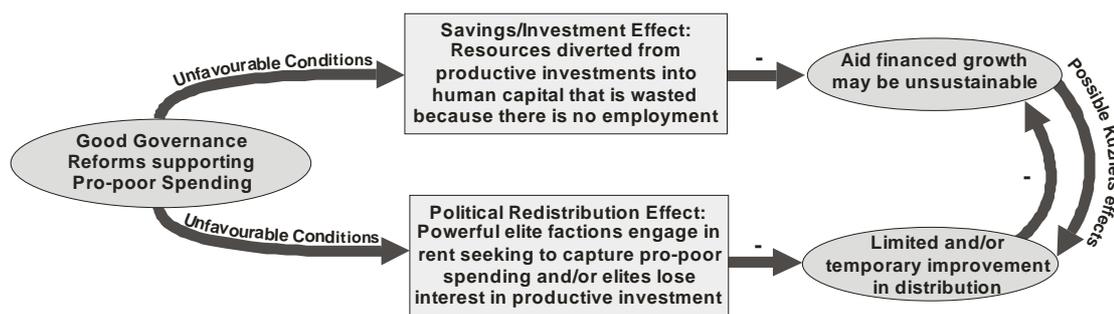
For the political redistribution effect to be positive in this case, without a negative impact on investment or investor confidence, we require some further implicit assumptions. We have to assume that the distribution of power in society is such that once the poor mobilize to sustain the allocation of a greater share of public goods to the poor, or to demand redistributive programmes through the tax system, the rich will not be able to resist, and therefore will not try to resist. This assumption is necessary to ensure that adverse effects on investment do not follow. With these assumptions, the improvement in accountability – triggered by a combination of good governance reforms and the catalyst of aid-financed pro-poor spending – could result in a sustainable improvement in distribution. This would directly assist poverty reduction through the arithmetic effect shown in Figure 1, and may further assist poverty reduction through growth effects if the conditions are appropriate for sustaining growth in the way suggested in Figure 14.

These political assumptions may be unrealistic in most developing countries. Pro-poor spending is typically targeted at the bottom ten to fifty per cent of the population who are, by definition, the very poor, and mainly targeted to the population below the poverty line. This part of the population may be very numerous, but, typically, they are not collectively very powerful in developing countries. As a result, most of the redistributive conflicts in poor countries are between different fractions of the rich and the ‘intermediate classes’ (Khan 2005). The relatively small amounts of aid-funded pro-poor spending in poor countries are unlikely to change this fundamental distribution of power or result in an alternative set of powerful poor-led organizations emerging that can change the way governments are held to account.

The most optimistic of the realistic outcomes is that dominant political factions do not react adversely to protect their interests in the face of aid-financed pro-poor spending. The more pessimistic outcomes are that the politically dominant organizations of the not-so-poor will work out ways to capture much of the pro-poor spending. When this happens, this ‘rent seeking’ by intermediate class interests to capture more aid resources can quickly have adverse effects. Not only is delivery to the poor likely to be affected, but more seriously, the attention of the political elites is likely to be diverted towards sustaining the aid economy rather than being focused on the

enhancement of productive capacity. A combination of adverse conditions can result in the focus on pro-poor spending having much more limited or even adverse effects on distribution and growth. The adverse scenario is shown in Figure 15. Here, pro-poor spending and good governance reforms fail to achieve growth accelerations, and on the political redistribution side, the main result is the diversion of mainstream patron-client factions into particular types of rent seeking. Unfortunately, this type of political response is all too common in developing countries.

Figure 15. Adverse Scenario: Good Governance and Pro-Poor Distribution



The effect of good governance reforms and pro-poor spending in many countries has been to induce an elaborate set of rent seeking activities, beginning with the consultants and stakeholders who produce the PRSPs. As the pro-poor spending preferences of donors are well known, governments and stakeholders in developing countries have rapidly evolved skills in defining national priorities in line with activities likely to be funded. Ministries, departments and service providers of different types of pro-poor services have also frequently become aligned to absorbing and spending the inflow of resources. The poor can certainly benefit to some extent from immediate aid inflows, but it is questionable whether the type of sustainable pro-poor political realignment desired in the good governance framework has happened in any country receiving aid and good governance policy advice. The most pessimistic outcome is when the leading elites of the country begin to become dependent on pro-poor aid flows as sources of rents. The difficult and risky task of organizing the productive transformation of society can then take a back seat.

Conclusions and Alternatives

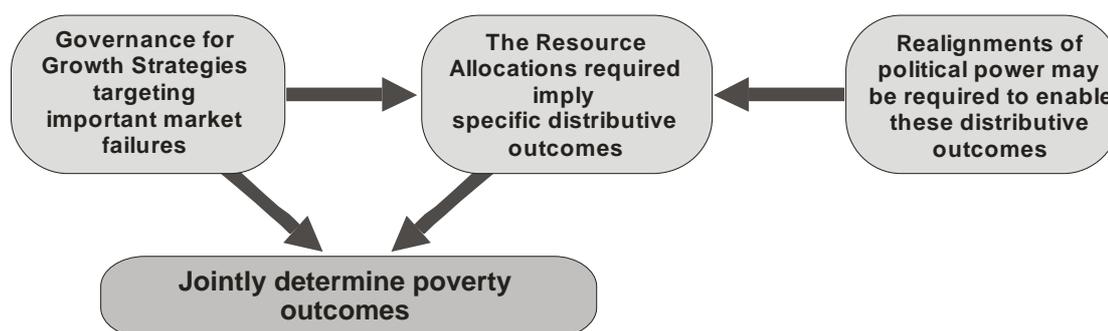
The good governance reform package is easy to support as a set of desirable objectives for developing countries to aspire to. There is considerable doubt as to whether this package is implementable to the extent that it can make a dent on the serious market failures that developing countries are subject to. There is therefore an argument that the good governance agenda may divert attention from the task of developing growth-enhancing governance capabilities in poor countries. On the other hand, there is the possibility that good governance reforms, particularly when bolstered by support for pro-poor spending as a way of improving government accountability, can have a direct effect on redistribution. Since poverty reduction is arithmetically a function of growth and improvements in distribution, this effect of good governance could have a significant effect on poverty reduction.

The available data provides no evidence that good governance is associated with improvements in distribution. The weakness of the data has to be kept in mind, but there are also theoretical reasons to question the presence of strong relationships between good governance reforms and sustainable redistributive changes in favour of the poor. Given the weak political power of the poor and the implausibility of significant shifts in that power balance coming about as a result of pro-poor spending, it is more likely that good governance reforms will themselves be subject to new forms of rent seeking by elites. There is considerable anecdotal evidence from many developing countries that this is indeed most likely to happen. If so, any improvements in distribution are likely to be largely the result of aid-funded spending that is not likely to be sustainable over time. The reduction in poverty that is arithmetically achieved is therefore also likely to suffer if aid is eventually removed.

Our theoretical analysis of the relationship between growth and distribution suggests that sustainable improvements in distribution have to be consistent with a growth strategy, and our analysis of the arithmetic of poverty reduction reminds us that while improvements in distribution are important, the long-run reduction of poverty can only be assured by sustainable growth. Aligning redistributive agendas with the needs of growth strategies so that an acceptable mix of growth and distribution is achieved is obviously the only viable strategy. For this to be achieved, we may need to think outside the good governance box, not only as a growth strategy, but also as a redistribution strategy.

An alternative and pragmatic approach to thinking through the links between growth and distribution and the effects of poverty is suggested in Figure 16. A growth-enhancing governance strategy would focus on assisting developing countries to identify critical constraints to growth and develop the institutional capacities to address them. There may be many strategies, each prioritizing different sectors and market failures, each with different distributive implications. Keeping poverty reduction in mind means we should rule out growth strategies where the poor have to pay a significant price, even if only in the short term. The desirable mix of growth and distribution is obviously a political judgement and different political parties could well reach different judgements. The second part of the argument is very important. Whichever strategy a political leadership assesses as optimal is likely to have distributive implications that some powerful groups may resist. A successful growth strategy will therefore also have to give some attention to its feasibility. A strategy is only feasible if it can be implemented with achievable changes in the distribution of power. But all policies are likely to require some realignments of political power through the construction of appropriate new coalitions or the political weakening of specific distributive coalitions who would have opposed successful implementation of that specific growth strategy.

Figure 16. A Pragmatic Approach to Growth and Distribution



Clearly, the implicit realignment of political power in a pro-poor direction that good governance strategies attempt to achieve may be neither achievable nor, in any obvious way, linked to the implementation of a specific growth strategy. The challenge of poverty reduction is to make explicit the assumptions behind the linkages and to explore alternative strategies that require less demanding assumptions for their effective implementation.

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