Department for International Development*

Making Markets Work Better for the Poor

A Framework Paper

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* The Department for International Development (DFID) is the UK government department responsible for promoting development and the reduction of poverty. For further information, please contact William Kingsmill (w-kingsmill@dfid.gov.uk) or Christian Rogg (c-rogg@dfid.gov.uk).

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Abstract

This paper is intended to provide a framework for understanding the role of markets in achieving the International Development Target of reducing poverty, and for identifying ways of strengthening the pro-poor functioning of markets. It considers these questions both overall and in relation to markets for finance, labour, land, and staple foods.

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1. Introduction

Markets are key to the achievement of IDTs

The International Development Target of reducing by half the proportion of poor people in the world by 2015 can only be met if high levels of economic growth are achieved and poor people are able to benefit from it. Markets are important because they affect the rate and patterns of growth, and the ways in which poor people can improve their livelihoods.

This framework paper will contribute towards a shared vision of how markets can work better for the poor through assisting broadly-based growth. It is intended as a means for structuring consultation, identifying critical questions and eliciting the views of stakeholders. It considers the roles of the main private, public and non-governmental players, and the ways in which governments, and donors such as DFID, can encourage pro-poor market development. This work is linked both to the implementation of the 1997 White Paper, and to the White Paper on Globalisation. Specifically, it takes forward one of the eight priorities for action, 'Make markets work better for the poor', identified in DFID's Economic Well-Being Target Strategy Paper (*Can one billion people be lifted out of poverty by 2015? Economic growth, equity and security*).

Principal users are seen as a range of development practitioners, principally DFID advisers and desk officers. Other users include DFID's outside partners (developing country governments, multilateral agencies, EC member states, UK researchers, the private sector, and civil society organisations).

2. Markets and Poverty Reduction

Poverty, growth and markets

Poverty is complex, dynamic and diverse

This section explores ways in which improving the operations of markets contributes to reducing and ultimately eradicating poverty. First, poverty must be seen as a diverse, complex and dynamic process. It involves low human development, income and consumption, and is characterised by inadequate access by the poor to assets, and return on these assets – human, financial, social, physical and natural. The poor are also vulnerable. Their income and consumption are variable and subject to shocks, yet they posses few means of managing this risk. As a result the poor can move into and out of poverty in response to relatively small changes in economic conditions. Finally, poverty can result from – and contribute to – exclusion from social, political and economic processes (including markets). A particular feature here is the exclusion of groups defined in terms of their gender, class, ethnicity, and caste.

Effective poverty reduction requires progress in many areas

If measurable reductions in poverty are to be achieved, progress will need to be made across a range of areas:

- Growth of assets, incomes and consumption.
- Empowerment of the poor, enabling them to influence the structure and operations of public and private institutions.
- Greater equalities of opportunity for poor people to build up their assets and generate livelihoods.
- Security, to counter physical and economic vulnerability that drives people into poverty or threatens the sustainability of their exit from poverty.

Growth is central… but patterns of growth matter

Economic growth is a powerful driver of sustained poverty reduction. Indeed, over time it is a necessary – though not sufficient – condition for poverty reduction. Growth is driven, *inter alia*, by institutional change and technological advance, and it both contributes to and results from the build-up of assets. Growth also involves using one type of asset to enhance others (e.g. investment in education and health in order to build up human capital). In the process, it can be destructive of

certain assets – through for instance undermining some forms of social capital or leading to environmental degradation – while building others. Over time, vigorous growth is strongly associated with poverty reduction, and rising levels of productivity are likely to enhance living standards. But trade-offs also exist, especially in the short to medium term. The processes of growth may for instance marginalise traditional social arrangements that may have been beneficial to some poor families. Increasingly, therefore, analysts focus on the 'quality' of growth, as well as growth itself.

Economic change is about the evolution of institutions … including markets

The process of economic change prompts institutional innovation as economic agents push for markets to function more efficiently. Examples include the collective provision of public goods such as improved information, and even regulatory frameworks. The process of economic development also involves a progressive shift from informal towards more formal institutions, such as the replacement of social norms and codes of behaviour with formally specified, perhaps legally binding, arrangements. In this way, the role of the state in determining the institutional framework for markets is likely to grow over time. While the rising productivity that is generally associated with these processes can be expected – in time – to benefit poor people, the extent to which they are able to influence the nature of these processes is an important determinant of patterns of growth and the impact of markets on poverty.

While the process of economic growth will often involve the expansion of market relationships, many key decisions are not taken on a market basis. Often, they are taken within households, communities, firms and governments. In affecting poverty outcomes, markets are thus complementary to accountable and competent states, and to inclusive social networks.

Pro-poor market development

Markets are institutions. They can be understood both as 'rules of the game' (for instance the set of norms and standards that affect exchanges) and as organisations (including those in the private, non-governmental and public sectors), which enable participants to trade in factors of production, or in outputs or consumer goods and services. Pro-poor markets are understood as those that contribute to social and economic outcomes in which the poor gain substantially and often more than proportionately.

Pro-poor markets can have direct and indirect impacts

The pro-poor effects of markets may be both direct (in that poor people are enabled to participate in a particular market as buyers or sellers) and indirect (in that the markets promote patterns of growth and development that lead to more than proportionate gains for the poor). Direct impacts may result from improving terms of access to those markets in which poor people themselves participate (obtaining food or selling their labour on more favourable terms, for instance). An example is provided in the grain markets of eastern and southern Africa where deregulation has led to an expansion of local labour-intensive grain mills at the expense of the market share of large-scale flour mills. At least as important, however, are those markets that have an indirect effect (mainly through affecting the overall growth rate and pattern of growth), but in which poor people typically do not themselves directly participate. These include, *inter alia,* markets for foreign exchange, agricultural derivatives, internationally-traded commodities and capital, and power and telecommunications.

… think in terms of pro-poor market *development*

Attempting to define pro-poor markets according to structural characteristics (formal or informal, large-scale or small-scale, etc) generally fails, as lessons appear to be highly country-, sector-, or institution-specific. It is more productive to focus on the ways in which markets function – that is, for instance, how transactions costs are reduced, or information asymmetries are dealt with. It is also useful to analyse how markets change over time – in effect, to ask whether the terms of access of the poor are improving or worsening – rather than to consider markets in a steady state. Pro-poor market *development* is therefore a more useful concept than pro-poor markets.

The functioning of markets for poverty reduction

How does market development help to reduce poverty?

Market development can contribute to enhancing growth, empowerment, opportunity and security in a variety of ways and through a range of mechanisms (some of which are illustrated in Table 1). The development of *market institutions* will increase potential growth rates through, for example, reducing the transactions costs involved in exchange, enabling more types of goods and services to be bought and sold (including through changes to property rights) and allowing prices to reflect scarcity and information. Improved *access to markets and services* – for instance for education and skills – can both empower the poor and expand their livelihood opportunities. Security will often be strengthened by improved access to markets. For example, through recourse to insurance and other markets, the poor are in principle better able to manage risk and, through access to food markets, to stabilise supplies and prices.

Table 1. Links between markets and strategies against poverty

Strategy against poverty	Potential positive roles of markets	Examples of market factors that may work against the poor
Growth	Promoting efficiency in allocation and use of resources.	Market distortions (capital subsidies) Disabling economic framework. Market failures.
Empowerment	May provide incentives for local organisation.	Structure and functioning exclude poor. Poor not involved in setting market rules; lack of voice.
Equality of opportunity	Access to assets, services. Markets for assets of poor (notably labour).	Adverse or weak institutions. Weak demand for assets of poor people Market failures (e.g. credit markets and excessive market power)
Security	Risk management. Supplies of food and other basic requirements.	High transactions costs Incompleteness of markets (e.g. insurance markets).

How do markets change so that they support the poor?

Market change is driven by a mix of economic, political and social factors. Economic factors can include technological development which alters absolute or relative prices; political factors might involve changes to prevailing ideologies, or shifting balances between urban and rural interest groups; and social considerations might include the decline of traditional authorities which exercised influence over market operations. Enabling the poor to influence these drivers of change – such as through co-operating to increase their economic influence, or politically through ensuring the accountability of representatives – is an important dimension of empowerment. However, poor people in general, and some disadvantaged groups, including women, ethnic minorities and isolated rural communities in particular, are likely to be especially poorly placed to effect market change.

For markets to work better for poor people, they need to facilitate the access of the poor to assets, and enable them to use these assets to generate livelihoods and to reduce vulnerability. To do this, markets must become progressively more developed, and accessible to poor people.

Market development, through *inter alia* transactions costs falling, information flows improving, and integration increasing, is necessary for broad-based growth, not just for the poor. However, the central functions of allocating scarce resources and enabling productivity increases require not just improvements in the operation of a given market; markets need also to become progressively more complete in the sense of reducing the extent of missing markets, so that wider constraints can be overcome. As an example, trading on a local produce market may be highly competitive at the same time as participants operate within severe infrastructural constraints that prevent economies of scale being exploited. Market development can also occur through the creation of a new market where none existed before; technological and regulatory changes have for instance brought into existence competitive telecommunications services, some of which are accessible to people in isolated rural areas or in low-income parts of cities.

Even successful market development does not, however, assure a pro-poor outcome. There are circumstances in which markets can exclude the poor, notably those who are destitute and have little to offer the market. Markets may even harm the poor, where they reinforce inequalities in other institutions. For instance, markets are closely bound to specific social contexts, and can reinforce unequal local power relationships and undermine certain forms of social capital. Bonded labour in Nepal – where financial debts, reinforced by the social context, can tie succeeding generations – is one such case. The exclusion of the poor is often a result of *market segmentation*. For instance, in financial markets the poor typically do not have access to low-cost formal sources of capital, and in labour markets they are restricted to casual employment where employers have less incentive to provide a living wage. At international levels the exclusion of poor countries or regions from key markets can reduce their opportunities for trade and economic growth. At local, national and international levels, therefore, there will be cases where explicit redistributive measures may be needed to assure pro-poor market outcomes. Annex 4 on land markets explores one such issue.

How do markets fail?

An essential feature of improving market performance is the ability to deal with *market failure* (Box 1), both in a particular market and in linked markets – for example, failure in credit markets will often restrict the ability of farmers to hire in labour.

Box 1. Market failure

This paper uses the term 'market failure' as it is understood in welfare economics literature which identifies the following types of market failure:

- *Public goods*, which the private sector will not supply (or will under-supply) because it cannot appropriate the benefits
- *Externalities*, which exist when the production or consumption of a good or service has spill-over effects which are not reflected in the market price
- *Market power and economies of scale*, where barriers to entry create market power, enabling monopoly rents to be earned and depressing production
- *Asymmetric information*, where parties to a transaction have different information about the nature of the exchange. In credit and insurance markets and in input supply systems, information failures are especially widespread
- *Cost of establishing and enforcing agreements* may be so high as to increase risks to the point at which markets do not exist.

Correcting for market failures provides one widely-accepted justification for market intervention --- whether by the state or by private sector or co-operative agencies, the latter often involving self-regulation or other collective action. State intervention actions to correct for market failures are often warranted --- provided that state failure or the costs of intervention do not outweigh the original market shortcoming. Means of state intervention may include *inter alia* regulation (including regulation to encourage the private sector, for instance through strengthening intellectual or other property rights), taxation and subsidies, and direct public provision of services and infrastructure.

Externalities and the environment

Market failures in the form of *externalities* are a principal reason for environmental degradation, and commonly call for community or state action, whether at local, national regional or international levels. Actions may be needed to manage *common pool goods* where it is difficult to deal with the free rider problem (locally in the case of unregulated common grazing, or nationally with fishing within territorial waters), or to address external effects (internationally with global warming resulting from greenhouse gases emitted by consumers and industry, at the moment primarily in developed countries).

Rural and urban markets

While market failures are potentially present in all areas, some forms may be more severe in rural than urban areas. Typically, rural markets are affected by: the lower population densities and greater incidence and depth of poverty that combine to diffuse and diminish demand; seasonal and year-to-year variability reflecting the importance of renewable-natural-resource based sectors; particular difficulty in achieving cost-effectiveness in providing infrastructure, social and economic services, and other public goods; high transactions costs; and social capital that includes stronger traditional relationships than is the norm in cities. Both the analysis of markets and measures to strengthen their pro-poor functioning need to take account of such local realities.

Market and non-market solutions

Markets are not the only institutions which provide for exchange, co-ordination and allocative decisions (see Annex 1). Non-market or hierarchical solutions will be required in a range of situations, either alone or in combination with markets. The New Institutional Economics literature explains the internal organisation of firms and of governments as using hierarchical structures as alternatives to markets (or as complementary to markets where governments and firms, as part of their own governance arrangements, combine hierarchies with internal markets). Circumstances in which there may be a case to explore non-market solutions include those where transactions costs are persistently so high that markets fail or do not exist, or where tendencies towards concentration, with resulting abuse of market power, strong in situations in which government capacity to regulate monopoly is limited.

Risk and uncertainty

Risk, uncertainty and investment

Pro-poor outcomes require enhanced means of managing risk and uncertainty, whether at the household or macro-economic and sectoral levels. Poor households need to be able both to reduce vulnerability to shocks and stresses and to invest in assets to improve future livelihoods. As important as investment by poor people themselves is investment in the wider economy which will create demand for poor people's products and services. Reducing uncertainty will help lower the threshold for risk-taking and is therefore an important component of any intervention aimed at stimulating investment and growth.

Risk may take the form of supply risk (affecting the ability to participate in the market as a seller of produce or services --- such as family labour for instance) and of market or price risk. Risk has multiple possible sources: supply risk may result, among others, from climatic variability or family illness. Market risks may result from ineffective or unaccountable institutions, or weak or absent linked markets such as those for insurance.

Successful risk management involves both the ability to identify and evaluate risk, and access to means of coping with it. Poor people are likely to be badly placed in both these respects, highlighting the importance of risk analysis as a dimension of promoting pro-poor markets. Mass and individual information (some of it publicly provided) may assist poor people with risk evaluation. Supply risk for the poor may be managed through measures that include infrastructural investments, and improved advance warning and insurance. Market and price risk may be reduced through improved market institutions, such as hedging mechanisms, whose effects on the poor are often indirect rather than through their being directly accessible to poor people. Market development can assist poor people in managing some aspects of risk (improving food supplies in the event of climatically-induced local shortfalls), while fragmented or poorly regulated markets can increase other sources of risk.

Complex and adverse effects

Clearly, the role of markets in poverty reduction is not straightforward. While this paper suggests that their role is generally positive, it is sometimes ambiguous, and may even be harmful. Careful judgement is always needed to determine where and how intervention is needed. Three areas of concern may be highlighted:

- First, changes in regulation for some markets may increase systemic risks if the mode of regulation is inadequate. The most obvious example is capital market liberalisation to allow short-term capital flows. These reforms, intended to develop markets, can have major consequences for growth and poverty if they lead to instability in capital flows.

- Second, the development of markets changes, and in some respects may increase, the risks and vulnerability faced by the poor. For instance, increased market integration reduces the risks faced from local supply and demand shocks, but increases vulnerability to external shocks. In some cases there may be trade-offs between the expansion of opportunity and increased risk.

- Third, if the rules of the market are determined in a manner that is biased against them, the poor may be disadvantaged. There is a large literature on how modes of agricultural market regulation in South Asia operate in the interests of local elites and lead to the reduction of competition. Also some groups (such as women and children) can be especially vulnerable to exploitation in some labour markets – an issue that is explored in Annex 3. An important question is whether and how the poor can or should be able to influence the rules for these markets.

Markets and livelihoods.

To function well from a pro-poor perspective, therefore, markets need not just to be efficient, but also to work in ways that enable participation by the poor and improve their terms of access. At the micro-level, markets affect livelihoods of poor communities and households through three principal mechanisms:

What role do markets play in the livelihoods of the poor?

- *Facilitating access to human, financial, social, physical and natural assets*. Clearly markets can do this only up to a point: they cannot alone remove the more extreme inequalities of asset ownership or political empowerment. However, as Annex 4 on land markets indicates, improved operations of markets can ease access of the poor to assets, whether by sale or rental. Further, they can enable the poor to exchange a relatively abundant asset for another, for instance by using labour to obtain livestock or capital.

Box 2. Markets and sustainable livelihoods principles.

Markets represent one means by which SL principles can be applied in strengthening pro-poor development. These principles are: putting people at the centre of development (so that policies and institutions work in ways that are congruent with households' livelihood strategies); holistic (in that SL approaches seek to identify the most pressing constraints faced by, and promising opportunities open to, people regardless of sector or geography); dynamic (in that they seek to support positive patterns of change); building on strengths (seeking in the first instance to identify potentials); emphasising macro-micro links (underlining the importance of macro-level policies and institutions to the livelihood options of communities and individuals, and stressing the case for higher-level policy to be informed by lessons learned at the local level); and sustainability (broadly understood to include environmental, economic, social and institutional dimensions). SL approaches emphasise the importance of assets (human, financial, social, physical and natural), mediated through policies and institutions --- including markets --- in enabling households successfully to enhance their livelihoods.

♦ Enabling households and communities, through *improving the returns on their assets*, to improve their livelihoods, both by raising the overall level and by managing risk to reduce vulnerability. At the heart of this is the role of markets in enabling the poor to raise their productivity. Labour markets (Annex 3) are of particular importance to the livelihoods of the poor, given the paucity of other assets. However, the poor, if not the absolute poorest, if given the chance, are also known to save financial assets, and require secure means of doing so (Annex 2). Livestock are commonly a store of wealth among pastoral peoples and are available to be sold or bartered for grain.

♦ The *meeting of consumption needs*, especially but not only for staple foods (Annex 5). The great majority of the poor, in both urban and rural areas, are net buyers of food, and therefore require food markets that are efficient, accessible and provide a degree of price stability and predictability. This requires the integration of local, regional and national markets. The progressive integration of national food markets into world markets, especially of grains, underlines the importance of international efficiency and equity in the operations of the markets, and the need for developing countries to have access to international stabilisation mechanisms such as derivatives markets. Relief of emergencies such as famines have also been shown to work better if schemes such as food-for-work are organised via established food markets.

Analysing pro-poor market development

How to determine if markets are working for the poor

A framework for determining whether markets are working well from a pro-poor perspective is set out in table 2. This also identifies – for illustrative purposes – some of the specific areas of analysis that need to be considered. The main features of markets are grouped into four categories: the enabling framework; market failures; power relationships and exclusion; and linkages to other markets. This framework is used in determining appropriate actions by different stakeholders (section 3 below) and is applied to particular markets (section 4 below, and annexes 2-5).

Table 2. Pro-poor market development: defining characteristics

Market Characteristic	Domain of intervention or collective action	Illustrative areas for analysis
Enabling framework	**Macro-economic policy**	Extent of inflation. Capital subsidies displacing labour.
	Law and Administration	Integrity, accessibility and representativeness of judicial system. Property rights.
	Political and social culture, governance	Democratic accountability of representatives. Extent of male-dominated institutions.
	International markets	Open access to developing country products. Instability of capital flows.
Market failure	**Public goods**	Adequacy of rural infrastructure. Lawlessness, insecurity.
	Externalities	Pollution of natural resources
	Market structure and power, monopoly	Degree of competition. Land ownership concentration.
	Information asymmetry	Education on citizens' rights. Legislation on product description Quality of agro-chemicals Access to credit
	Transactions cost	Contract enforcement mechanisms. Barriers to formal financial sectors.
Adverse power relations, exclusion	**Regulations anti-poor, anti-women, ethnic bias**	Female property rights limited, inheritance laws Law favours formal enterprises

	Organisational bias	Gender awareness in service providers
	Social relations link to markets	Bonded labour obligations inherited. Intra-household control of cash sales
	Market segmentation	Barriers to accessing formal credit. Barriers to formal labour markets.
Inter-market linkages	**Risk management**	Facilities for savings. Accessibility of insurance mechanisms.
	Linked markets	Means for transmitting migrant remittances Extent to which credit market failures limit labour markets

Analysis must be location- and market-specific

The full range of analysis that needs to be undertaken to assess whether markets are working to benefit the poor is considerable (table 2), and needs to be undertaken locally and in relation to specific markets. However, some of the main points that commonly arise are:

- A macro-economic policy framework that promotes broad-based growth is fundamental. Rapid inflation appears to harm the poor more than the rich (who have more means of maintaining the real value of assets), although the evidence is mixed on moderate levels of inflation.
- A legal and administrative system that is accountable and honest appears to favour the poor who are generally too weak to operate effectively in more 'negotiable' systems
- The costs to developing countries of protectionist tendencies in OECD markets for products in which they have a comparative advantage (e.g. textiles and farm products) have been extensively documented.
- Market failures are widespread, and may be so extreme as to cause markets to fail to develop altogether.
- The linkages between markets and social and political structures and processes are manifold and will often exclude or otherwise disadvantage the poor.
- Market segmentation (whether caused by ethnicity, formal/informal rigidities, and rural/urban or other geographical divides) is generally harmful to the effective workings of markets and to the poor.
- The ability of people to manage risk is fundamental to their ability to escape poverty on a sustainable basis. However, market mechanisms enabling risk management are often weak, which may call for collective or public provision of help in managing risks.

Linkages between markets are crucial, with failures in one (e.g. financial markets) worsening the terms of access of the poor to another (e.g. labour markets).

3. Making markets work better for the poor

To make markets more pro-poor we must focus on public and private roles…

The central challenge in the growth of pro-poor markets is one of institutional development. Both the 'rules of the game' and organisations – public or private – need to support higher overall growth as well as growth paths which are more pro-poor. Rising to this challenge requires greater attention to the appropriate roles for public, private and non-market actors as well as enhanced accountability and effectiveness throughout government. Using the framework set out above (Table 2), Table 3 identifies some actions at different levels that may be taken by: (i) households and firms; (ii) community, market and professional groupings; (iii) the state at national and local levels; and (iv) international actors.

There is no real alternative to a series of mutually reinforcing relationships between private, public and non-governmental actors, where all parties are pressed to become increasingly effective and accountable. Sometimes these relationships will take the form of partnerships based on shared purposes among the participants; sometimes there will be conflict, for instance between regulators and the regulated, when at least short-term interests fail to coincide.

What types of action can be taken by households …

For ***households***, local-level actions by households to strengthen their political voice, improve their negotiating positions in markets and provide for local public goods, may enhance their terms of access to markets. Women may be especially disadvantaged and yet have opportunities for group action. Often, however, the scope for effective action will be limited by hostile local power relations and social contexts, especially if the organs of the state are not supportive of local empowerment.

… firms…

Firms that grow, diversify, and stimulate demand for labour are an essential mechanism for assuring the pro-poor impact of market development. A principal focus of government policy must be to enable them to thrive. While in many respects at the individual level firms will be more influenced by the wider environment than they will be determinants of it, there will also be scope for them to organise, though there are also risks of collusion, discussed in the next section.

…market associations …

Firms will often have a long-term interest in improving the efficiency of market operations, and in particular in ensuring that some public goods (such as infrastructure, credible information, and generally accepted norms and standards) are provided. Interventions generally take the form of ***collective actions***, such as self-regulation by market participants (backed up by sanctions that may involve pressure on offenders), managed jointly by Chambers of Business for instance. There will inevitably be tensions, however, around the management of free-riders, and collective actions can readily become attempts create and abuse market power on the part of those who are already powerful. A common form of collective action will have the aim of lobbying governments. For their part, governments will normally want to consult market and professional associations, both as a source of information and as part of a consultative process with stakeholders.

..community associations …

Organisation by poor households can be an effective means of strengthening political voice and of improving access to markets, for instance through trades unions or group-based involvement with financial markets to reduce transactions costs and improve information flows. However, a vicious circle of disempowerment, isolation and social division means that this is no panacea. Co-operatives, for instance, frequently encounter official hostility if they become sufficiently effective to challenge political or private interests.

… NGOs…

Local ***non-governmental agencies*** may enhance pro-poor market impact, depending on whether they are representative organisations (e.g. women’s or farmers’ groups) which strengthen political influence or improve the terms of members’ access to particular markets, or they are service-providers not subject to full commercial pressures (e.g. NGOs providing credit and savings facilities for otherwise unbankable clients).

Table 3. How can different participants act to strengthen pro-poor market development

Domain of intervention or collective action	Roles and levels of action			
	Household and firm	**Community, market and professional associations**	**State (national and local)**	**International**
Economic policy	Exercise of political voice.	Dialogue with government	Macro-economic and sectoral policy. Pro-poor budgeting. Consistency, for investor confidence	Stabilisation and adjustment programmes. Debt initiatives. Reform OECD policies (trade, agriculture)
Law and Administration, governance		Self-regulation of markets.	Increase accountability, effectiveness of law and public sector. Assure freedom of association.	Support to legal and civil service reforms
Political and social culture,	Participate in representative organisations. Enhance gender equality.	Trade associations more inclusive.	Improve accountability of political process.	Support governance programmes.
International markets			Policy to address supply-side constraints.	Open access to developing country products
Public goods	Take part in common property management.	Collective provision. Institutions for common property.	Taxes/subsidies. Regulation. Funding or direct provision.	Taxes/subsidies. Regulation. Funding or direct provision.
Externalities		Collective action to internalise.	Taxes/subsidies. Regulation. Funding or direct provision.	Taxes/subsidies. Regulation. Funding or direct provision.
Market power, monopoly			Competition policy. Improve infrastructure. Address statutory monopolies.	Address international concentration.
Information asymmetry		Collectively invest in information flows	Regulation (e.g. product description). Invest in information.	Fund information generation and dissemination.
Transactions cost		Collective action	Infrastructure. Contract enforcement.	
Regulations anti-poor, anti-women, ethnic bias	Organise locally (e.g. women).	Reforms to associations. Community education	Political and social reforms. Public education. Empowerment of local groups	International NGO networks.
Organisational bias		Reforms to service providing entities	Changes to regulatory frameworks. Public education.	Core labour standards.
Social relations link to markets	Traditional authorities address inequalities. Strengthen social capital – organise locally, use kin groups.	Transparent self-regulation.	Legislate for social change (on e.g. bonded labour.) Core labour standards	
Market segmentation		Collective action for access to markets.	Regulatory framework to reduce barriers to integration.	
Risk management	Mutual household support, kin groups.	Group saving. Market integration.	Economic policy. Social policy. Safety nets.	Design of stabilisation, adjustment. Capital market reforms. Debt management. Support for safety nets.
Linked markets	Diversify livelihoods and assets. Develop child-care services.	Deepen financial markets, link to insurance markets.	Financial and labour market reforms.	International trade reforms.

… and the state, both nationally and locally

As economic development proceeds, the role of ***the state*** in contributing to the institutional framework for markets progressively grows more important. Increasingly, markets will only function well, for the poor as well as for other participants, if there is an active and accountable government, capable of undertaking critical tasks competently. These include:

- Creating a supportive economic, legal and administrative framework, which *inter alia* provides for freedom of association and effective contract enforcement
- Identifying market failures and ensuring that corrective measures are taken (except where the costs and risks of state failure are worse than the market failure the measures are intended to correct)
- Taking cost-effective actions to ensure that market processes and outcomes are acceptable from a poverty perspective. This may include an agenda of social and labour legislation, of strengthening local institutions to enhance participation by the poor, as well as of addressing the distributional underpinnings of markets (e.g. through land reform) and supply-side constraints, for instance through sectoral policies and programmes.

If governments decide to intervene in the workings of a market they will have to consider a range of possible instruments for intervention, including:

- Regulatory change. Banking regulations, for instance, can contribute not just to the enabling framework for growth, but also to expanding the scope for financial services that are accessible to the poor. Price controls may have a role where there is scope for abuse of monopoly power, though enforcement is difficult and effects sometimes counterproductive.
- Institutional reform at national (e.g. the judicial system), meso (e.g. sectoral reforms), or local levels (e.g. creating an enabling framework for people's organisations).
- Affecting absolute and relative price levels through subsidies, taxes and tariffs.
- Funding of public goods, for instance infrastructure, basic research, or general information (such as national statistics, or crop forecasting).
- Direct participation in markets as a supplier or customer.
- Assisting the poor in risk management, including through providing safety nets.

The regulatory framework is crucial…

The regulatory framework (see Annex 1) is of particular significance. All markets require a regulatory framework, a set of rules and conventions that structures the actions of market participants. A regulatory framework is a collective good since the system is available to all participants in the market system and use by one individual does not reduce the scope for use of the system by other participants. Regulations also create economic rents and so imply a competition to determine who secures these rents. Providing a regulatory framework therefore faces the problem of overcoming incentives for free-riding that are common to all collective and public goods. While self-regulation through collective action by market participants will often have a role to play, the state will usually be central in sustaining the regulatory framework for markets, deriving from its monopoly on the legitimate exercise of coercion and taxation.

…but using it may be problematic

However, the use by individuals of the state enforcement machinery is invariably costly and often unreliable, underlining the need for generalised social norms to sustain co-operative economic behaviour without requiring constant resort to legal enforcement. Equally, the control of the regulatory system by corrupt officials and politicians invariably means that the implied rents add further to income inequalities and harm the poor.

Government needs to be realistic

The actual combination of the modes of intervention that is appropriate for a given country, market and period cannot be determined in general terms – rather, it must be based on location-specific analysis. The capacity of the state to undertake particular functions at particular times will be crucial in this regard, and strengthening the capability of the state will often form part of an approach to pro-poor market development. However, there are cases in which complex regulatory functions are unrealistically proposed in countries where the state is not capable, either currently or in the foreseeable future, of carrying them out.

Beware the concept of the neutral government

For two reasons, there is also variation in the extent to which the state can be treated as an impartial and efficient provider of public goods, agent of regulation, or supporter of local empowerment. First, the power of the state may be used for predatory purposes, in favour of particular class or sectional interests. This may reflect direct control of the apparatus by a particular group, or be the outcome of competition between politicians for the support of interest groups. Second, even if the objectives of the policy makers are in fact developmental rather than predatory, there is a problem of monitoring and control of the agents to whom the exercise of state power is delegated. Political hostility to market development may link to social factors, as when there is a tendency to vilify certain occupations (e.g. traders, money lenders and water carriers) and to characterise them as exploitative, notwithstanding the important functions they often perform.

Beware, too, unintended results

While some form of public action to affect the functioning of markets is often necessary, the need for great care is underlined by the experience that the effects of intervention have sometimes been unexpected, and even worse than the initial problem. Price interventions, while sometimes desirable, for instance to control possible abuse of market power, are often problematic, not least because they are analytically very demanding. Producer price controls may be ineffective (if set too high) or counterproductive (if set too low, thus discouraging production). Price supports are also problematic: for instance in agriculture they have the effect over time of raising land prices, which may work to the advantage of a group of beneficiaries (large land-owners) other than those originally intended. The need to avoid unforeseen and harmful outcomes of interventions intended is also illustrated by the history of many Development Finance Corporations discussed in Annex 2 on financial markets.

What can be done at the international level?

Measures to make markets work better for the poor need to be taken not just at national and local level, but also ***internationally***. As at national levels, well-functioning markets internationally call for an agenda of institutional development that is both accountable and effective.

The need for international public goods…

Globalisation processes – which create opportunities for the poor, but also raise challenges – are highlighting the need for global public goods to be provided, including *inter alia* intellectual property rights regimes, food labelling and safety standards, information generation and dissemination, agreements on the treatment of economic migration and capital flows, and taxation conventions. While considerable progress has been made on some of these areas in terms of widening areas of consensus, enhancing openness and accountability of international agencies involved, and formalising agreements, much remains to be done. Persisting obstacles placed by OECD countries in the way of developing countries' access to key export markets require attention, as do export subsidies provided by the EU through the CAP.

... and other actions ...

There is also much to be done at international level to support the development of markets within low-income countries. Measures include: the design and implementation of stabilisation and adjustment programmes; peace-making and peace-keeping; debt relief; support to improved governance; and the control of corruption.

… with roles for official bodies, NGOs and corporations

Much of this agenda requires a lead role to be played by governments and by international agencies. However, civil society in all its diversity is also increasingly active, for instance in raising awareness of corruption, in influencing (with mixed results) debates on trade, and in promoting fair trade. Many trans-national corporations are also recognising their interest in improving standards of environmental management and social responsibility.

4. Markets for finance, labour, land and food

How can pro-poor markets be developed in four key markets?

The framework for understanding pro-poor market development has been applied to four key markets: those for finance, labour, land and food. Each of these is explored in an annex (see annexes 2 to 5) in terms of its importance to the poor, experience with past interventions, and priorities for future approaches for governments and DFID.

Financial markets (Annex 2)

Financial markets are key to poverty reduction… but they seldom work well for the poor.

Past interventions in financial markets provide many lessons, both positive and negative, for pro-poor market development. For at least forty years, governments have rightly acted on the basis that effectively functioning financial markets are fundamental to the prospects for successful development. At the level of individual livelihoods, financial markets play potentially critical functions: they can be a principal means for the poor to get access to financial assets; through facilitating saving, they are one means of reducing the vulnerability associated with uneven and unpredictable year-to-year changes in circumstances; and they can help convert illiquid assets into liquid ones in the event of emergencies. But since they frequently fail to discharge these functions with any real effectiveness, their improvement is rightly seen as a key element of the pro-poor agenda.

What can the state do to address this?

Unfortunately public actions to intervene in markets and develop institutions have had mixed results in bringing about improvements in the operations of financial markets and in ensuring that the poor, and in particular the poorest, benefit. Interventions from the 1950s to 1970s have included numerous actions which could claim some pro-poor objective but with generally disappointing outcomes. Main features were control of interest rates at low nominal and real levels, the establishment of development finance institutions, and proactive state sponsorship of small-scale rural credit programmes. The subsequent wave of reforms from the 1980s formed part of the wider response to economic crisis, and focused on removing wider distortions to financial markets and on micro-economic reforms to wayward institutions. While progress has been made, the main lesson learned is that there is no easy route from a state of financial repression to one of generally liberal financial markets. From the perspective of pro-poor financial markets, perhaps the most encouraging trend during the 1980s and 1990s has been the growth of diversity among intermediaries, notably specialised financial institutions serving low-income clients and supporting community-level action, and non-bank financial institutions.

The state's main priority is to create a sound financial system

For the future, the building of more effective pro-poor financial markets remains a major challenge for governments and development agencies wishing to reduce poverty. The first priority is to complete the task of creating a sound and functional overall financial system. Beyond this, the myriad gaps in the provision of financial services of all types and for the poor need to be addressed by judicious interventions, designed and carried out with great care. There is still a financing gap hindering micro, small and medium enterprises in many countries, with a continuing need to reduce the costs of financial services which undermines sustainability. For the very poorest, priorities are to focus on reducing transactions costs and to go with the grain of proven community and co-operative developments rather than trying to displace them.

Labour markets (Annex 3)

The market for poor people's labour is crucial to poverty reduction…

Well-functioning labour markets are critical to the pro-poor agenda at both the macro and the household levels. However, many poor individuals and families experience difficulties in using their labour to generate livelihoods, resulting in under-employment or unemployment. Further, the under-utilisation of human capital will have a significant negative impact on wider economic performance. In particular, poorly functioning labour markets will hamper the ability of the economy to respond to economic reforms or adjust to external shocks.

… and is closely linked to the wider market for the goods and services they produce

Demand for the labour of the poor, being substantially derived from the demand for the goods and services they produce, is intimately linked to the performance of the wider economy. The labour market is also closely bound up with other factor markets on whose performance it depends. The labour market's poverty-reducing effects are therefore not separable from the effectiveness of measures to improve the wider economy and to strengthen pro-poor growth patterns.

More liberal trade is important… but its poverty impact can vary

There is no real dispute about the general income-raising and efficiency effects of more liberal trade as mediated through the labour market, but its distributional and poverty-group impacts are complex. For example, the pre-trade reform situation in some developing countries has been characterised by significant protection of labour-intensive activities. Hence, as protection has been reduced, some unskilled workers have suffered losses of both income and employment. Most importantly, the trade reforms of the past 20 years have occurred at the same time as crucial technological developments that have favoured skilled over unskilled labour, explaining many of the losses of income and employment seen amongst unskilled labour in some developing countries. These trends have further underlined the importance for poverty reduction of the public and private sectors combining to ensure the supply of the skills demanded by a changing labour market.

Ensuring that markets correctly value labour and capital is key

Initiatives to improve macro-economic stability and policy coherence and credibility, and to strengthen the operation of factor and product markets will impact on the operation of labour markets, and should serve to strengthen the potential positive impacts of globalisation. Governments need to review regularly the full range of policies and programmes to ensure that they are free of distortions that would unduly encourage the substitution of capital for labour, whether directly or indirectly. Supply-side measures are also needed: in the longer term, sustained public and private investment in human capital will be central to strengthening the access of the poor to labour markets.

OECD countries also have important roles to play in promoting pro-poor labour markets. In the first place, they need to be consistent in their approach, and support developing countries in processes that affect access to international markets for labour-intensive products (such as agriculture and textiles). Second, they may support codes of practice for core labour standards whose direct and indirect effects are understood and carefully judged from a pro-poor perspective. And third, developed-country approaches to promoting the international migration of skilled and unskilled workers should bear in mind not just the interests of the receiving country but also the impact on the source countries and households.

Land Markets (Annex 4)

Access to land is vital for the rural poor

Access to land, and the conditions and security of that access, critically affect the livelihoods of many of the world's poorest households. Households with access to land are better able to use their own labour to generate livelihoods through the production of agricultural commodities or through hunting and gathering activities. They are also better placed to attract capital and labour from outside the household, and to build social capital. Depending upon the socio-economic context in which they operate, households may achieve access to land as a result of rights acquired through one or more forms of customary land tenure (which range from relatively exclusive individual rights through to regulated or unregulated common access) to individual title to a legally-defined freehold.

The experience with land reform has been mixed

Given that extreme disparities of land ownership often accompany rural poverty, attention has often been paid to land reform as a means of addressing the distributional underpinning of the land market. However, while there have been successes, experience has been mixed. Land redistribution in South East Asia immediately after World War II was comprehensive and was regarded as having had a positive impact on poverty and landlessness, creating as it did a class of property-owning peasants. Resettlement schemes in Latin America, however, have been much less successful and highlight a number of potential problems with land reform initiatives: political interference at the administration of every stage of the process (e.g. from whom land is expropriated, what compensation is paid, and to whom land is allocated); problems in agreeing key concepts; delays in land allocation; and a lack of consultation with intended beneficiaries. Meanwhile, the introduction of individual title on formerly customary land has in practice often led to increasing landlessness, and skewed distribution, without necessarily increasing agricultural investment and productivity.

An enhanced focus on rental markets would help

An active land rental market or strong tradition of sharecropping may go some way to improving both the efficiency of land use and the quality of opportunities available to the poor, however unfair and inefficient the distribution of land use rights, and the process by which such distribution came about. Accessing land through renting rather than purchasing, although offering less scope for use as collateral, may have a number of advantages for the poor. In many situations it is politically more feasible than land reform, and it is a more flexible arrangement, with lower transactions costs, implying a reduced reliance on (often distorted) capital markets, and reduced exposure to risk. Nevertheless, governments and donors have generally paid less attention to land rental markets than to issues of ownership and title.

The way ahead…

Future government intervention in land markets may most usefully focus on: recognising customary tenure systems, and integrating them into the legislative framework; encouraging the development of rental markets; promoting women's rights to land, in particular through the reform of inheritance laws; facilitating the management of natural resources at the community level; and promoting the participation of stakeholders in the development of land policy.

Staple food markets (Annex 5)

Food is bought, sold and consumed by the poor; its price is crucial to the quality of their livelihoods

Staple food markets are of fundamental importance for economic development, political stability, and the welfare of the poor. The poor spend a high proportion of their disposable income on staple foods, whilst the production, processing and marketing of staple foods are important sources of livelihoods for many poor people. The efficiency of the food marketing system also has implications for the macro-economy, through its effects on the rate at which urbanisation, industrialisation and agricultural specialisation can occur, as well as the level of real wages. At international level, continuing restrictive practices among OECD countries in food markets create costs and distortions for many developing countries.

Government intervention has often made things worse

Governments in low-income countries intervened especially intensively in staple food markets during the 1950s to 1980s, though using arrangements that often had their roots in the 1930s, in an effort to achieve one or more of the following: a reduced risk of famine; a reduced level of import dependence; cheap and stable consumer prices; higher and stable producer prices; and efficient and non-exploitative marketing systems. The various instruments employed, however – administrative controls, establishment of marketing agencies, and limiting competition – have often had adverse effects: high marketing costs, wide margins between producer and consumer prices, unintended welfare transfers between producers and consumers, reduced opportunities for labour-intensive processing and marketing, and costs to the fiscus.

States have been forced to rethink their intervention as costs soared

Widespread liberalisation and deregulation have been driven by ministries of finance during the 1980s and 1990s, prompted by conditions imposed by donors, because of high fiscal costs and macro-economic stress. In eastern and southern Africa, reform has been subject to frequent policy reversals and has been partial, with continued significant intervention by the state in trade and prices, and through the operation of strategic grain reserves. The notable exception is South Africa, where the final set of agricultural marketing reforms during the 1990s was comprehensive, the impetus coming from domestic political change.

Reforms have been positive, though price instability is a problem

The results of reform to date have been generally positive. They have included a significant reduction in marketing and processing margins, a wider range of products on the market, and a reduction in the fiscal costs of the system. The benefits of efficiency gains have generally accrued to consumers and a limited number of well-situated producers, although price instability in some countries has increased for both producers and consumers. Liberalisation does not, however, appear to have boosted grain production. There is also controversy over the impact of marketing reforms on linked markets, for instance in cases where an output marketing agency had previously had an incentive to provide producers with credit provided it had an assurance of being able to sell their produce.

Challenges remain for policy makers

A number of issues continue to face policy makers. First, few systems have resolved the problem of how to contain the effect of price instability on producers and consumers without inflating marketing margins and incurring fiscal costs. One of the few is South Africa, with its highly developed financial system, a large-scale private sector, and the almost complete withdrawal of the state from marketing. In this case, new institutions that provide for the management of price risk have emerged. Second, there are still uncertainties over how to boost smallholder productivity, especially where smallholder credit and input supply systems have broken down. Third, there are similar uncertainties over how to encourage the growth and deepening of small-scale trading and processing enterprises. Finally, greater regional market integration will remain elusive whilst governments are unwilling to relinquish their capacity to intervene in domestic food markets. An emphasis on policy consistency and coherence, infrastructural development, and initiatives to strengthen the capacity of the private sector are likely to be important components of successful agricultural marketing strategies in the future.

5. Guiding principles for donor agencies and specifically DFID.

What should donors do to make markets more pro-poor?

The role of market development as a central element of reaching the Economic Well-Being IDT highlights the importance of DFID and its partners committed to this target integrating market perspectives in the full range of its activities. Nine priorities may be identified for how DFID does this.

Nationally and locally

1 **Assist the governments, private sectors, and research communities of developing countries to strengthen analytical and policy-making capabilities to support pro-poor market development.**

2 **Work with partners in the private sector and NGOs to clarify the direct and indirect impacts on the poor of applying core environmental, labour and social standards.**

3 **Provide support to local organisations in developing countries that seek to strengthen the political voice and market access of poor people, and in particular women.**

4 **Continue to prioritise support for the reform, strengthening and broadening of the financial sector in developing countries, at the level both of the enabling framework, including prudential regulation and supervision, and of enterprises, including micro-enterprises.**

Internationally

5 **Act coherently with other UK government departments to ensure trade and aid policies are favourable to pro-poor market development in low-income countries.**

6 **Assist in developing international financial governance arrangements so as to minimise the incidence of financial shocks and their impact on developing countries.**

7 **Work with international agencies, including the IMF, World Bank, EC and UN, including its food agencies, to ensure that macro-economic and sectoral reform programmes, and food aid flows, reflect best practice in supporting pro-poor market development.**

Internally

8 **Subject all UK-funded aid programmes to scrutiny from the perspective of strengthening, and at a minimum not harming, pro-poor market operations, with a particular focus on identifying means of reducing transactions costs.**

9 **Work with private sector partners in the UK and abroad to develop a more comprehensive understanding (including among DFID staff) of the needs of the private sector in developing countries, and to ensure that the way DFID does business is market-friendly.**

6. Monitoring and measuring pro-poor market development

Given that markets are an integral part of achieving overall development objectives, outcome indicators for pro-poor market development will be closely linked to the IDTs, particularly that for halving the proportion of the world's population living in poverty.

Monitoring should focus on process rather than impact areas…

This paper has emphasised that markets can have a range of potential impacts on the poor, through a variety of means. The linking of specific market development activities with particular welfare outcomes is thus complex. As a result, there is a strong practical case to be made for focusing monitoring and evaluation effort for this area of work on *process* rather than impact. Following the formulation in tables 2 and 3, most of the indicators involved are defined in terms of function rather than structure. Table 4 sets out indicatively some of the verifiable indicators, and means of verification. To be meaningful, these will need to be applied in specific countries or regions within countries, and to specifically-identified factors that affect the poor in particular markets.

Given the nature of markets, some of these indicators will be quantitative, but many will be heavily qualitative, and will depend on reviews and studies, which are likely to be costly. Prioritisation and selectivity will therefore in practice be needed.

Table 4. Pro-poor market development: examples of monitoring indicators

Market Characteristic	Domain of intervention or collective action	Indicators of pro-poor change	Means of verification
Enabling framework	**Economic policy**	Extent of inflation. Capital subsidies displacing labour. Wages as percentage of GDP.	Economic surveys. Economic reviews.
	Law and Administration	Integrity, accessibility and representativeness of judicial system. Property rights.	Civil service reform programmes. Analyses of legal systems.
	Political and social culture, governance	Democratic accountability of representatives. Extent of male-dominated institutions.	Governance analysis. Gender analyses.
	International markets	Open access to developing country products. Instability of capital flows.	OECD reviews of key markets IMF.
Market failure	**Public goods**	Adequacy of infrastructure. Lawlessness, insecurity.	Sector reviews.
	Externalities	Pollution of natural resources	Environmental situation analyses
	Market power, monopoly	Degree of competition. Land ownership concentration.	Sector reviews. Land records.
	Information asymmetry	Education on citizens' rights. Legislation on product description Quality of agro-chemicals	Curricula; reports on public campaigns. Fertiliser, etc., studies.
	Transactions cost	Contract enforcement mechanisms. Barriers to formal financial sectors.	Legal reviews. Financial sector studies.
Adverse power relations, exclusion	**Regulations anti-poor, anti-women, ethnic bias**	Female property rights limited, inheritance laws Law favours formal enterprises	Gender analyses. Sector, legal reviews.
	Organisational bias	Gender awareness in service providers. Unionisation.	Gender analysis.
	Social relations link to markets	Bonded labour obligations inherited. Intra-household control of cash sales	Social surveys. Household, gender studies.
	Market segmentation	Barriers to accessing formal credit. Barriers to formal labour markets.	Sector studies.
Inter-market linkages	**Risk management**	Facilities for savings. Accessibility of insurance mechanisms.	Sector and client surveys.
	Linked markets	Means for transmitting migrant remittances Extent to which credit market failures limit labour markets	Economic reviews. Special studies, Sector surveys.

Annex 1

Conceptual Issues in Analysing Markets

Although the concept of a market is central to economics, it is rarely defined in the economic literature. This contributes to what can be an endemic tendency among economists to equate actually existing market systems with the theoretical constructs of neo-classical economics and hence to attribute to them the welfare and efficiency properties of the Arrow-Debreu model. Harriss-White (1999) notes the definition provided by Fourie of the defining characteristic of market exchange as an "economically qualified purposeful interchange of commodities on the basis of *quid pro quo* obligations at a mutually agreed upon exchange rate… in a cluster of exchange and rivalry relations." She notes the advantages of this definition as emphasising the coexistence of both the direct bilateral relationship between buyer and seller, and the framework of adversarial competition within which this takes place. The definition also requires exchange to be mutually agreed, but not necessarily mutually beneficial, and so avoids making (ideological) assumptions about market performance.

The modern economics of information places strong limits on the extent to which a market economy can in principle be decentralised through the price mechanism as a result of market incompleteness and information imperfection (e.g., Stiglitz, 1994, p.62). As a result, externality, nonconvexities and moral hazard effects are pervasive in market systems. This creates a presumption that it is important to understand the implications of missing markets and information asymmetry and imperfection in a given context. Newbery (1989) however argues that this does not necessarily create a presumption in favour of state interventions to solve these problems. He suggests that the only likely cases where this will be effective to deal with market incompleteness relate to the supply of information and the institution of coercive insurance arrangements.

A market system is therefore one in which the allocation and exchange of resources is determined in a decentralised way by those who own (control) them, based on price signals. However, even within a market economy, many if not most economic decisions do not take place through a market relationship. This includes decisions within government and firms, as well as in households.

While economists tend to focus on collective action as a way of exercising market or *economic power* through the formation of cartels, collective political action also affects market outcomes through its influence on the exercise of:

- *State power* (involving state regulation and taxation of, and participation in, markets)
- *Associational power* (the systems of internal regulation created by market participants), and
- *Social power* (inherent in social and cultural institutions, ideologies and value systems).

As a result, "in the real world ... the realms of state and market, public political and economic systems, are densely and inextricably intertwined" (White, 1993). The process of institutional development is structured by relationships of power. North (1989) notes that “the rise of impersonal rules and contracts means the rise of the state, and with it unequal distribution of coercive power.”

Markets as Institutions

Markets are economic institutions, where institutions may be defined as “socially devised constraints on individual action” (Clague, 1997, following North). Institutions are “sets of rules that are recognised and frequently followed by members of the community and that impose constraints on the actions of individual members”. New Institutional Economics stresses that “the costs of transacting are the key to the performance of economies” (North, 1989, p. 1319). The effectiveness of market institutions depends on their capacity to reduce transactions costs of various types. The definition and enforcement of property rights are central in enabling markets to function.

North (1989) asserts that market transactions (outside cases where there is personal knowledge and ongoing reciprocal relationships between the participants) depend on “the development of a third party to exchanges, namely government, which specifies property rights and enforces contracts, and second on the existence of norms of behaviour to constrain parties in interaction.” The move from administrative to market based allocation mechanisms requires the creation or existence of a structure of institutions to support market exchange. The experience of many of the transition economies has shown that the creation of appropriate institutions may be a formidably difficult task even where physical infrastructure is relatively strong and education levels high. The experience of agricultural marketing reform in low-income developing countries suggests that the absence of institutions for handling risk and contract enforcement may seriously undermine the supply response in cases where the state withdraws from the direct provision of marketing services, even if this leads to higher prices (Barrett and Carter, 1999; Dorward etc).

The Regulatory Framework

Marketing systems require a "regulatory framework", a set of rules and conventions that structures the actions of market participants. A regulatory framework is a collective good since the system is available to all participants in the market system and use by one individual does not reduce the scope for use of the system by other participants. Regulations also create economic rents and so imply a competition to determine who secures from these rents. Providing a regulatory framework therefore faces the problem of overcoming incentives for free-riding that are common to all collective and public goods. In addition, any non-simultaneous exchange creates time consistency problems.

Four requirements of a regulatory framework for a decentralised market system to function can be identified (Bromley 1993; Shaffer, 1980):

- A set of "ordered relations" between economic agents established by legal and social conventions that define and allocate property rights, entitlements, and delineate the legitimate scope of economic behaviour.

- Rules about transactions between economic individuals that define rights to exchange property rights, define what may constitute legitimate contracts, permissible and non-permissible forms of co-operation and competition, and establish rules on liability.

- A system of authority and legitimacy to enforce these rules, including penalties for delinquency.

- Mechanisms by which these rules can be adapted to changing economic and social circumstances while providing a predictable framework for market participants.

The state may have a key role in sustaining the regulatory framework for markets, deriving from its monopoly on the legitimate exercise of coercion and taxation. However, the use by individuals of the state enforcement machinery is invariably costly and often unreliable: for example, Berry (1993) discusses the pervasive "negotiability" of formal legal as well as of customary rights in an African agrarian context.

However, the costs of invoking legal sanctions are generally high. Platteau (1994a, 1994b) therefore argues that market systems depend on generalised social norms to sustain co-operative economic behaviour without requiring constant resort to legal enforcement. Further, these norms will not emerge spontaneously and may be undermined, since they may conflict with traditional systems of morality. These may limit the legitimate scope of profit-seeking behaviour towards social insiders (especially kin), and legitimise opportunistic behaviour towards social outsiders. One example is the "trader's dilemma" of combining the need to accumulate working capital with meeting social obligations. Evers and Shrader (1994) discuss possible social responses to this problem, including reliance on the immigration of trading minorities; the formation of ethnic or religious groups; investment in the accumulation of status (cultural capital); restriction to petty trade that does not require capital accumulation; and the depersonalisation of economic relationships. Moore (1994) however suggests that these problems are made more tractable by the widespread use of "institutional reputation mechanisms" (such as blacklisting by potential trading partners) within trading and business communities where the bulk of economic transactions in fact occurs. These may reduce the costs of ensuring that agreements between market participants are upheld and opportunistic behaviour controlled, without requiring reliance on a generalised morality of trust.

Non-market collective action (such as the formation of trade associations) can strengthen the bargaining and lobbying power of groups of market participants. It allows them to protect themselves against predation by other market participants or third parties. It also facilitates institutional solutions to some of the problems of co-ordination, public goods provision, and internalisation of externalities. On the other hand, collective action by market participants can also be used to restrict market access and reduce competition.

Modes of market regulation can be defined according the following taxonomy (Harriss-White, 1999; Shaffer, 1979):

- The object of regulation (structure, conduct, performance)
- The enforcement mechanism
- The degree of specification
- The type of regulatory incentives
- Contingencies for implementation, and
- Jurisdiction at the boundaries with other legal acts.

This framework can in principle be applied to any form of market, and also used to classify forms of market regulation reform (often generically termed "deregulation" or "liberalisation"). Harriss-White (1999) discusses the application of the framework to Indian agricultural markets. A general trend associated with globalisation is the move from national to international regulatory frameworks.

Pro-Poor Market Development

The performance of markets will affect both the overall growth rate of the economy (usually the principal driver of absolute poverty reduction) and the "quality" of growth, in terms of the proportion of the benefits of economy-wide growth that accrue to the poor. Therefore, processes of institutional development that reduce transactions costs and increase competition are likely in general to be "pro-poor", though market development is likely to generate new types of risk.

For instance, policy reforms (or infrastructure investment) that integrate local or national food markets into international markets will reduce vulnerability to locally generated supply or demand instability, but will increase vulnerability to exchange rate or international market fluctuations. Market development that supports more efficient ways of sharing risk (for instance allowing a move away from market interlinking) is particularly likely to be favourable to the poor. An example would be measures to strengthen the transferability of land rights enabling land to be used as collateral. This might (depending in part on local power relationships) allow a smallholder farmer to source input loans from other sources than from crop buying merchants. On the other hand, the property rights of the poor are often fragile, so that there can be a risk that measures to improve the marketability of assets (such as land, or privatised state assets) might prompt extortion from the powerful.

It is worth distinguishing two types of markets in this context. First, those that have a major but indirect influence on the poor (mainly through affecting the overall growth rate), but in which the poor typically do not themselves participate. This includes foreign exchange market, international trade, and international capital markets and

also telecommunications and power. Second, those in which the poor are direct participants.

Improving the performance of markets on which the poor are disproportionately dependent (either as buyers or sellers) is likely to be pro-poor in effect. Of particular importance are markets for unskilled labour and staple food. In addition to institutional developments that reduce transactions costs and improve market information in such markets, measures specifically to improve the terms of access of the poor may be required. The terms of access to many markets differ systematically according to the gender, race, caste or class of market participants (Harriss-White, 1999 pp 14-23). Labour market discrimination may be especially important particularly for women, ethnic minorities and other disadvantaged groups (such as scheduled castes in India). Differential market access may reflect discrimination, but it may also be the result of particular transactions costs bearing more heavily on the poor. A simple example would be the inability to benefit from bulk purchase of food or other goods because of low levels of expenditure and lack of access to credit. Some of the problems of differential market access can potentially be addressed through collective action (such as the formation of co-operatives).

Another way of improving terms of market access could involve increasing the direct participation of the poor in the regulation of the market. The move towards reducing national level regulatory discretion in favour of internationally agreed regulation (for instance through the WTO) poses what can in some cases be a sharp and politically sensitive conflict between participation and other objectives.

Annex 2

Financial markets and the poor

Introduction and summary

Past interventions in financial markets provide many lessons, both positive and negative, for pro-poor market development. For at least forty years, governments have rightly acted on the basis that effectively functioning financial markets are fundamental to the prospects for successful development. Unfortunately public actions to intervene in markets and develop institutions have had very mixed results in bringing about improvements in the operations of financial markets and in ensuring that the poor, and in particular the poorest, benefit. Early public policy interventions largely ignored the poverty dimensions. Later interventions have included numerous actions which could claim some pro-poor objective but with generally very disappointing outcomes. Main examples are control of interest rates at low nominal and real levels and proactive state sponsorship of small scale rural credit programmes. For the future, the building of pro-poor financial markets in a more efficient manner remains a major challenge of governments and development agencies wishing to reduce poverty.

Financial markets are understood as encompassing a diversity of institutions from the small-scale local to the formal commercial sector, and increasingly NGOs and non-bank financial institutions. They provide a variety of functions including those of savings mobilization, the provision of credit and other intermediation functions, money transmission, and payment. The distinction between classes of financial market largely hinges around the degrees of regulation which relate to them, formal markets being the most well regulated and controlled.

Importance of financial markets to the poor

At the macro-economic and sectoral levels, well-functioning financial markets are essential to broad-based income growth through their role in mobilising scarce capital from domestic and foreign sources; ensuring its allocation to efficient uses; and thereby intermediating the process of structural change which is at the core of the development and productivity-enhancing process. At the level of individual livelihoods, financial markets play potentially critical functions: they can be a principal means for the poor to get access to financial assets; through facilitating saving, they are one means of reducing the vulnerability associated with uneven and unpredictable year-to-year changes in circumstances; and they can help convert illiquid assets into liquid ones in the event of emergencies. But since they frequently fail to discharge these functions with any real effectiveness, their improvement is rightly seen as a key element of the pro-poor agenda.

In the literature, there are naturally differences of view as to the relative importance of financial markets in poverty reduction, and as to the effectiveness of alternative

approaches. Hulme and Mosley (1996)[1] conclude that 'credit is potentially a prime weapon against rural (and urban) poverty'. Among the weapons that are generally feasible (they take the view that land reform is often not practicable) 'credit is the only one which places a tangible capital asset in the hands of the poor…' (p.202). However, Adams, Graham and von Pischke (1984)[2], in an analysis that contributed to a change in international development practice, took the view that, at least as then practised, programmes to intervene in financial markets through providing credit for the poor were ineffective or damaging. These views are potentially reconcilable. The theory that credit can help the poor can be perfectly sound but the practical policy responses to this insight may have been defective.

Past approaches

The dilemma faced after independence in Africa and much of Asia from the 1950s onwards was that, while improved financial services and increased amounts of capital at national and household levels were considered essential for development, the formal pre-existing private banking system did not seem able to respond (Brownbridge and Harvey 1998). Banks lent to large-scale formal businesses, often urban-based and owned by ethnic minorities. To the extent that lending reached rural areas, it served primarily agri-business and estate agriculture. In the early post-independence years that lending was firmly rooted in the needs of colonial agriculture and mining. It was certainly not for the poor, nor for women, nor for small-scale enterprises. The informal financial sectors, insofar as they were recognised at all, were seen as exploitative. It was commonplace in the early literature to advocate policies to create new institutions to mitigate these biases.[3]

The first wave of reforms in the 1960s and 1970s was designed to deal with these shortcomings. While there was variation between countries, most post-independence governments, with the active support of development agencies, adopted strategies based on active intervention in the markets. These were designed to supplement capital available from local savings, and to direct investible resources towards so-called "priority" areas --- administratively-determined. While there was disparity between countries in the intensity of the resulting financial repression, policy reforms often included: nationalisation of commercial banks; the creation of new and more populist commercial banks (e.g. all three countries in East Africa); the establishment of state-owned development finance institutions (DFIs --- generally dependent on concessional funds from donors); administrative controls over interest rates (designed to hold rates below market clearing levels); and the general re-direction of most capital funds for re-allocation via the state[4]. At the same time, informal sectors were ignored, or actively discouraged through regulations designed to discourage usury. In few, if any, cases did the institutional separation of informal and formal sectors break down, although this period did see the beginning of NGO support for semi-formal finance institutions, and of indigenous non-bank institutions.

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[1] '*Finance against Poverty'*.
[2] Title…
[3] A good example is E.T.Nevin, *Capital Funds in Underdeveloped Countries*, ……1975(?)
[4] This is discussed in much greater detail in World Bank, *World Development Report*, 1989 [check date and title]

The more active the financial repression, the more disastrous was the result of these reforms. Negative real interest rates resulted in sub-optimal levels of intermediated savings and its effective intermediation to investment; politicised banks became part of crony patronage arrangements; DFIs remained subsidy and donor-dependent; most services did not reach the poor, let alone the poorest; little progress was made in allocating capital to efficient uses, and savings, investment and growth were undermined. The resulting financial losses often remained hidden for long periods because of poor accounting and regulation but rose inexorably in many cases to destabilise macro-economic management. Many newly-created financial institutions --- pension funds as well as banks --- were badly if not dishonestly managed and this also resulted in significant losses to the household savers who placed their funds in this way.

Pro-poor financial markets – the Indirect Approach

The extremely poor record of financial sector development in the early post-independence years has led to a new conventional wisdom (or at least a Washington consensus) that no one - poor or rich - gains any benefit from a malfunctioning financial system. Hence the *sine qua non* of a pro-poor financial market policy since 1980 has been that of getting the financial sector as a whole working with improved efficiency. This greater efficiency in turn is expected to result in improved overall productivity, faster growth and so a greater prospect of removing more people from poverty.

The wave of reforms associated with this part of the logic began during the 1980s and early 1990s as part of a wider response to economic crisis in Africa and elsewhere, with financial sector reforms following on from economy-wide stabilisation and structural adjustment. These reforms resulted from a wider reassessment of the role of government which led to more selective interventions, and from mounting evidence of the poor performance of many aid-funded projects intended to support DFIs. Governments increasingly allowed interest rates to rise to positive real levels, sought to strengthen regulatory systems (which were woefully weak in many instances) and undertook micro-economic reform of state-owned financial institutions including a good deal of re-privatisation.

The effects of the reforms, which in many countries were undertaken in unstable macro-economic circumstances, have been mixed – perhaps not surprisingly[5]. Some of the greatest distortions in what were the most repressed financial markets have been addressed; where fiscal deficits are under greater control, governments have become less prone to monopolising domestic savings; some regulatory regimes have been strengthened (a development of increasing importance given the growth of non-bank institutions); and the operations of some wayward state and private institutions have been brought under control. However, the attention paid during this period to wider economic management reforms arguably led to the marginalisation of the interests of low-income groups and small businesses. A case can be made that the closure or contraction of DFIs reduced the levels of services available, especially to

[5] There is an inevitable transition problem. Many years of financial repression coupled with high or repressed inflation is bound to be associated with a period of unrealistically high real rates of interest once the liberalisation eventually begins.

rural areas; in practice, however, few of the poor had had prior access to the services provided by these organisations. Equally, temporarily high real interest rates undoubtedly damaged production activity in some countries including some which provided employment and income to low income groups. The main lesson learned in that there is no easy route from a state of financial repression to one of generally liberal financial markets.[6]

Pro-poor financial markets – the Direct Approach

The Micro-Finance Revolution. From the perspective of pro-poor financial markets, perhaps the most encouraging trend during the 1980s and 1990s has been the growth of diversity among semi-formal intermediaries, notably: specialised financial institutions serving low-income clients and supporting community level action; and non-bank financial institutions, often indigenously-owned. Bangladesh and the Grameen Bank is the pioneer in the area providing financial and other supporting services to millions of poor, if not the very poorest, clients. But that same tendency has emerged on a very large scale also in Latin America and parts of Asia. The movement has gone global with local approaches being tried in many countries, given momentum by the achievements of some of the pathbreakers. These institutional developments have often served in their second and subsequent stages to connect small scale local initiatives with larger formal banks and other financial institutions possibly even in richer countries. This has brought larger blocs of money to bear on uses which remain essentially local in nature. The extent of the phenomenon (reflected in the 1997 Micro-Credit Summit in Washington) is such that there is a danger of it being seen as a panacea for poverty. Within Bangladesh itself, the movement continues to diversify, with the Bangladesh Rural Action Committee (BRAC) recently becoming the first NGO to be granted a banking licence.

Hulme and Mosley's review of the poverty impact of micro-finance institutions found that they 'generally had positive effects on employment and technology, but those varied according to income group: poorer borrowers, being risk-averse and having fewer opportunities, were disinclined to invest income from a successful project either in a new technology or in hiring labour from outside the family, though they frequently increased inputs of labour from, and payments to, persons within the family, and this turned out to be an important channel of poverty reduction. Also the worst-off, in particular agricultural labourers, were not well represented even among borrowers from the case study institutions, and these groups still find it difficult to borrow from any source, a predicament referred to by Osmani (1989) as the exclusion problem. Material poverty, indeed, appears to have fallen amongst all but one of the borrower samples they examined, and there is some evidence that those using group organisation reduced the social isolation of women borrowers. But the schemes they examined did not substantially reduce the vulnerability of borrower groups to sudden falls in income and produced few benefits for the poorest or 'core poor'.' (Hulme and Mosley 1996, p. 201).

This finding reminds us of a fundamental point made in the body of the paper. This is that even pro-poor financial sector initiatives are likely to have certain pre-requisites

[6] Some of the transition problems are discussed in an African context in Alan Roe and Nii Sowa, "From Direct to Indirect Monetary Controls in Africa", *Journal of African Economies,* 1997

for fully successful operation. Where the opportunities available to the poor through asset ownership (e.g. land, education) are very low, or where their empowerment (e.g. the ability to control the use of their assets) is low, then financially-engineered solutions to poverty seem less likely to achieve their goals.

The scaling-up of the micro including the NGOs' financial services in response to their apparent promise as a means of reducing poverty also raises numerous problems of accountability and effectiveness. At first glance, the state should set up a strong regulatory system in order to reduce the abuses which might otherwise arise. But can it do this effectively given the very low scale of many of the micro institutions and the associated high unit cost of their supervision? Clearly the success of cooperative local financial institutions such as credit unions derives in large part from the high levels of compliance they achieve because of the close knowledge each member has of fellow members. This keeps both administration costs and loan-losses at a low level. Regulatory burdens on these institutions cannot be imposed without undermining this advantage to some degree. The evidence on the whole is that community-sensitive (including poverty-sensitive) lending can co-exist in this environment with the commercial success of the financial institution. What is much more difficult is to graft the social and poverty-sensitivity of lending on to more formal financial institutions which do not have the low costs associated with high levels of local knowledge and also carry large cost burdens associated with regulation.

Some of the same issues can be seen in relation to other semi-formal and informal institutions that have emerged in African and elsewhere in responses to the inadequacies and gaps in formal banks and non-bank financial institutions. There are many examples of institutions that have grown rapidly in countries with weaker regulatory regimes, and, in some cases, by-pass the high costs of regulatory compliance with banking laws (the fringe bank institutions in Kenya in the 1970s and 1980s and the Islamic banks in Egypt at the same time are prominent examples). Their proliferation owes much to the fact that start-up requirements have been low, and gaps in fragmented markets have created a potential clientele unserved because they are unable to satisfy the requirements of the established banks, but requiring more substantial services than can be provided by the informal sector. However, many of these new semi-formal institutions are fragile, with frequent bankruptcies and shaky security for depositors. Nonetheless, where regulation has been strengthened, there are signs that some of these organisations may achieve new combinations of risks and returns, and of information costs and contract enforcement, which may establish a lasting role in serving poorer clients --- but by no means the poorest.

Future priorities for governments and DFID

In seeking to reduce poverty, the high priority given to financial markets is entirely warranted. They are crucial to the prospects for enhanced access by the poor to assets and livelihoods.

- The first priority is to complete the task of creating a sound and functional overall financial system. This can support productivity enhancement and growth and in

this way will indirectly assist the poor. In the process some new financial products and services of importance to the poor may also arise.

- Beyond this the myriad gaps in the provision of financial services of all types and for the poor need to be addressed by judicious interventions directly targeted in that direction. But this has to be done with great caution since the past record in this area is mostly one of failure rather than success. The key is to go with the grain of proven community and cooperative developments rather than trying to displace these.
- Ensuring that financial markets are pro-poor involves both policy change to minimise distortions and, importantly, an agenda of institution-building in public, private and NGO sectors. Deregulation alone is far from enough and can be seriously anti-poor at least in the initial or transition phases
- The enabling framework for pro-poor financial markets is incomplete, both at the macro-economic level where stability is a pre-requisite for sound banking, and in regulation. The experience that financial sector reforms cannot work in a dysfunctional wider context has clear policy and institutional sequencing implications, *inter alia*: large and sustained budget deficits reduce the availability of funds for other uses; interest rate deregulation has been 'entirely helpful' to micro-finance development (Hulme and Mosley); and capacity limitations in many central banks and ministries of finance hinder development of the regulatory framework.
- Financial sector reforms must form part of a wider approach. Lack of effective demand for financial services, resulting from other constraints which undermine the profitability of economic activity, is often a reason for a weak financial sector. In the case of the poorest members of the society, very limited opportunities and degrees of empowerment will act as serious constraints on the poverty-reduction achievable from financial sector reform narrowly conceived.
- At the governance level, reducing the use of the financial sector for the purposes of patronage is a major and long-term task
- Given the extent of market failures in financial markets, a defensible case can be made for carefully judged subsidies provided that they provide incentives towards improved performance of the institutions involved and greater economic efficiency of the clients
- An important thrust of future financial sector reforms must be to reduce the fragmentation of the formal and informal which has hitherto excluded the poor from mainstream capital markets and lower-cost capital
- The growing diversity of financial institutions, in particular the non-bank financial institutions and NGOs, offers real prospects of widening participation in financial markets, at the same time as it underlines the crucial importance of governments being capable of effective regulation of very small units and at low cost.
- There are a host of positive lessons from the past which need to be taken into account in promoting pro-poor financial markets: 'What has now been established beyond all doubt, however, is that the option of lending at the bottom end of the capital market exists, and is not a financial black hole, if design is correctly done and the accompanying policy environment is not actively adverse' (Hulme and Mosley, p.206).
- Some of the factors contributing to success in micro-finance are: at the 'financial' level, 'market-determined interest rates, the availability of savings and insurance

> facilities, intensive loan collection, and incentives for borrowers and agency staff are positively associated with high performance.' (ibid. p.200).

A major challenge for the future is to provide financial services not just to the poor, but to the poorest. While the great difficulties involved should not be overlooked, promising approaches do exist, and should be further encouraged and supported. Overall, the task is not just to create a financial system based on sound banking principles, crucial as that is, but simultaneously to create space and incentives for a diversity of actors to offer sustainable services to the poor. There is no alternative to strong and accountable government using its powers, not for ill-judged interventions as so often occurred in the past, but to create the basis for a sound relationship between private and public sectors.

Annex 3

Labour Markets

Labour markets and poverty

Well-functioning labour markets are critical to the pro-poor agenda at both the macro and the household levels. Human capital is invariably amongst the most important of the assets available to poor individuals and families. But this asset is complex and the markets which impact on its value to the poor are varied, as are the policies and the institutions which impact that value. For example the standards of education and health available to poorer families will critically influence the value that they can derive from work. If they have uneven access then their situation is impacted adversely. But that may be the consequence of a poor geographical distribution of relevant infrastructure including schools, medical facilities and transport. At the point of employment, segmentation of markets on the basis of location, ethnicity, gender may diminish the return to human capital for some groups relative to others and become an important determinant of who is poor. Additionally, poor individuals and families often experience difficulties in using their labour to generate livelihoods, resulting in under-employment or unemployment. Further, the under-utilisation of human capital will have a significant negative impact on wider economic performance. In particular, poorly functioning labour markets will hamper the ability of the economy to respond to economic reforms or adjust to external shocks.

In many developing and transitional countries, labour markets do not function well, either because of barriers or other inefficiencies that arise out of the specific characteristics of the economy or society in question, or out of government interventions. Such distortions generally discriminate against the interests of poor households. They also mean that the macro-economy is less adept at adjusting to exogenous shocks. The possible sources of inefficiencies are numerous and often derive from problems in other markets. For example, the failures of financial and credit markets may result in sub-optimal levels of educational investment in human capital, leading to reduced income levels. Equally, a high degree of reliance on casual labour may result in wages remaining below the efficiency wage and so in a gradually depleted level of physical capacity in some workers. As a final example, there is strong evidence from rich and some poorer countries (e.g. many parts of the former Soviet Union) that inflexible housing markets can inhibit the inter-regional migration of surplus labour to take advantage of available jobs elsewhere.

The challenge for policy makers is to ensure that labour markets (and the markets with which they are closely associated) function well and operate in a pro-poor fashion.

Types of labour market

Labour markets tend to be complex, inter-connected, and inter-dependent. Nevertheless, helpful distinctions can be drawn between rural and urban; formal and informal; and casual and permanent labour markets.

- Urban labour markets can be characterised as consisting of a formal sector (large-scale public and private enterprises), and an informal sector (e.g. self employed workers and casual labour).
- Rural labour markets generally consist of agricultural labour (whether waged labour in commercial agriculture, or those involved in small-scale agriculture), and non agricultural workers. Both urban and rural markets also feature unpaid domestic labour[1].
- Formal labour markets are those where there is some structure and legal obligations associated with the labour contracts and above all certain rights and duties allocated to the workers such as defined hours of work, holidays, periods of notice, protection from injury via factory legislation etc. It may also incorporate pro-active collective action by workers via membership of guilds or trades-unions.
- Informal labour markets are those where these forms of structure and legal obligations are largely lacking. The boundary between formal and informal will often be fuzzy especially in developing economies – e.g. there may be widespread non-compliance with formal legal obligations to workers in some apparently regulated areas of employment. An important defining feature of informal markets is that it may be very difficult to measure the remuneration being paid for particular jobs since that remuneration may be partly paid in-kind and could also be irregular. So concepts like the "real wage" are difficult to pin down.
- Casual labour markets are common in agriculturally dependent economies where very short term employment of casual labourers provides the marginal labour input to employers not able or willing to offer year-round contracts to all their workers. Casual labour however need not be "informal" since the short-term employment contracts could be quite clearly defined and may even be subject to some regulation.

Finally, the locational distinction can also be extended to embrace spatially separated, and sometimes ethnically distinct, regions of many large economies. Such countries often fail to achieve efficient inter-regional migration of labour.

Labour market theory

The 1954 Lewis Model, which has influenced much labour market analysis, consists of a modern sector, where payments to labour equal its marginal revenue product, and a traditional sector where the price of labour is its average revenue product. Surplus labour in the traditional sector is released to the modern sector at a rate that depends on the rate of growth in the modern sector. Over a wide range of activity, the labour supply curve to the modern sector is effectively horizontal implying that the wage to be paid is effectively exogenous. The Lewis view of labour markets has been developed into a more sophisticated understanding of, amongst other things, labour migration, the reasons for wage differentials between the modern and traditional sectors, and the significance and complexity of the informal sector (which provides most of the employment opportunities available to the poor). Research into rural labour markets has concentrated on issues such as disguised unemployment, dualism, and inter-locking factor markets[2].

[1] *The New Economist Guide,* DFID, explores labour market typologies.
[2] Ibid.

The more recent literature has probed much more fully into the motivations underlying particular types of employment and the conditions attaching to it. One avenue has been elaborations of the early "efficiency wage" idea that the productivity of labour is crucially affected by nutritional intake. At its simplest level, this can show how involuntary unemployment can arise amongst the very poorest workers. Even if they offer their services at an extremely low (competitive) wage, they may not always gain employment. This is because employers understand that such a wage cannot provide enough nutrition to ensure a commensurate level of output. This is a clear example of a poverty-specific market failure. Elaborations on this idea have spelled out the connections between differential access to other assets (e.g. land, financial) and the levels of involuntary unemployment.[3] This introduces an important non-linearity into the minimum price that employers need to pay to gain access to one efficiency unit of labour. This is quite high for landless labourers because of the efficiency wage argument. It is lower for workers owning small plots of land – they gain basic nutrition independently of labour incomes. But it is high again for richer farmers with large blocks of land since their opportunity costs of offering labour service are so high. Involuntary unemployment still applies in this type of model to landless and some marginal farmers but voluntary unemployment may also arise in the case of larger farmers. The key policy insight is that land reform could greatly change this configuration not directly by granting the land asset to landless workers, but rather by eliminating the market imperfection in the labour market that causes the involuntary unemployment.

Other relatively recent approaches have used bargaining-game theoretic logic to capture the differential power attaching to employers on the one hand and incompletely organised and unionised workers on the other. This approach readily confirms the importance attaching to such concepts as the wage elasticity of labour demand, the relative bargaining-power coefficients of the two parties, and the worker's reservation wage. It too is compatible with the existence of involuntary unemployment for some groups of workers. Particularly interesting is the possibility that this approach can be extended to incorporate social norms and expectations in the way in which the bargaining power is exercised. Bardahn and Udry[4], for example, point out that in patriarchal societies, standards of fairness in wages and jobs as well as the social sanctions on wage undercutting may be gender specific. If both men and women in such societies internalise these cultural standards, then unfairness in employment contracts and poverty conditions for some women could be the result.

Links with other assets and markets

The example above is one illustration of the complex way in which labour and other markets can interact to influence poverty and the pro-poor agenda. The way that human capital is utilised by the poor to generate livelihoods may have a substantial effect on the other types of asset they have at their disposal. For example, the net effect of migrant labour arrangements on the social and natural capital at a household's disposal may be positive or negative depending on circumstances and the scope of the analysis (in particular the timeframe used).

[3] see for example, Dasgupta and Ray (1986)
[4] Bardhan and Udry (1999).

Equally, labour markets often have important linkages with other markets that have particular effects on the demand for labour.

- The demand for labour is derived from the demand for goods and services that labour produces. As a result labour markets may be extremely sensitive to the wider enabling framework for economic growth and to macro-economic shocks. However, the numerous imperfections of labour markets in developing countries make it unlikely that the market will behave in a simple or orderly way to major shocks such as a cut in total demand arising from a programme of stabilisation or structural adjustment.[5] The orderly response would be broad-based reductions in the real cost of labour that would minimise the loss of employment and real output. In reality, as the theoretical examples given above illustrate, there is unlikely to be an adequate decline in the real wage. Thus unemployment may rise and is likely to impact significantly on poorer workers.
- Labour is but one factor of production. The scope for capital and labour to substitute for each other is very significant, and is influenced by a range of policies, as well as technological and institutional change.
- Required levels of private investment in human capital may require some access to credit and so are dependent on reasonably well-functioning credit markets (see Annex 2).

Box 3.1 Labour markets and poverty in Thailand in the 1980s and 1990s

Thailand's example illustrates several central messages: the close relationship (positive and negative) between the labour market and poverty outcomes; linkages between rural and urban labour markets; the importance of the policy environment; the effect of external shocks; linkages between capital and labour markets; and the need for, and complexity of, safety nets.

Beginning in 1987, the Thai economy boomed. Over the decade ending in 1996, the growth of real GDP averaged almost 10 per cent per year (over 8 per cent per person per year). During this boom, the measured incidence of absolute poverty declined massively, from 32.6 per cent of the total population in 1988 to 11.4 per cent in 1996. This occurred despite an increase in inequality over the same period. The Gini coefficient of inequality at the individual level (larger numbers mean more inequality) increased from 48.5 per cent in 1988 to 51.5 per cent in 1996. That is, although the poor became better off in absolute terms during the boom period, the rich gained proportionately even more.

Real wages for unskilled and semi-skilled workers increased rapidly during the second half of this boom period. From 1987 to 1992 large numbers of workers moved from rural to urban areas. Although the incomes of these rural-urban migrants rose greatly as they found better paying jobs, the supply of cheap rural labour was so vast that real wages in urban areas scarcely rose, despite the economic boom. This pool of cheap labour began to dry up around 1992 and real wages in urban areas steadily increased. From 1992 to 1996, manufacturing wages in Thailand increased at around 9 per cent per year in real terms.

The currency crisis of 1997 had a profound effect on Thailand's labour markets, with real labour earnings contracting by about 8 per cent between 1997 and 1998, with wages declining much more for the less well-off groups than for the better-off. From 1996 to 1999, the incidence of poverty rose from 11.4 per cent to 15.9 per cent. The severity of the impact of the crisis on the poor highlighted the need for government efforts to protect the most vulnerable. However, the main programme, employment generation through public spending, only came to be implemented in 1999, two years into the crisis.

Source: Warr (2000)

[5] In this context, the sources of imperfection which are well documented for developed economies also apply. These include the impact of trade-union wage inflexibility; wage-indexation; minimum wage legislation; and unemployment benefits.

Globalisation and labour markets

Increasing international trade, improved and cheaper communications, and competition for foreign investment, have been two important factors in the internationalisation of labour markets in the developing world. This has raised many issues about how this intensified globalisation has impacted on the poorer segments of society.

As regards the greater integration of international commodity markets, the conclusion from standard trade theory is that freer trade should increase the demands for unskilled labour. This in turn should raise both the levels of employment and the remuneration of lower paid groups in developing economies. In short, it would be strongly pro-poor.

There is no real dispute about the general income-raising and efficiency effects of more liberal trade but the simplistic early view about their distributional and poverty-group impacts is subject to dispute. Various mechanisms have been uncovered which cast doubt on the earlier conclusion. The WDR 2000 refers to three:

- The pre-trade reform situation in some developing countries has been characterised by significant protection of labour-intensive activities as well as activities more in need of protection. Hence, as protection has been unwound, some unskilled workers have suffered losses of both income and employment
- Some liberalising economies in both developing and transition economies cannot really be characterised as being abundant in unskilled labour. They may instead have an abundance of land (Africa) or skilled labour (the former Soviet Union). If unskilled labour is in fact scarce, trade reform will have less impact on poverty.
- Third and most important, the trade reforms of the past 20 years have occurred at the same time as crucial technological developments that have favoured skilled over unskilled labour. The losses of income and employment seen amongst unskilled labour in some developing countries is explained by the pervasive technological shifts – the trade reforms are the means whereby these have been enabled to have greater and more rapid effects. This is especially true in those countries where the formalisation of labour and the granting of increasing rights and protection to labour have raised the costs of employment most significantly.

As regards factor markets that are complementary to the labour markets themselves, there is an even stronger backlash emerging against unqualified liberalisation. This is true in particular of financial and capital markets. The volatility and major crises associated with particular packages of reform (e.g. near full liberalisation of financial and external capital markets while exchange rates remain pegged) are now widely seen as a basic cause of the worsening living standards for the poor in countries such as Mexico and Thailand in the mid to late-1990s. In Mexico in particular, the short term gains in the period 1988-1993 from a pegged exchange rate (e.g. lower inflation and large portfolio capital flows), were cruelly paid for in the years after 1994 when the economy needed to make a painful adjustment to the 1994 crisis and the

instantaneous cessation of capital inflows. This example illustrates the non-symmetry in gains and losses between different income groups in the two phases just described: boom and bust/adjustment. In the adjustment phase, the labour markets were quite incapable of making a large enough adjustment to avoid serious increases in unemployment. The problems for the poor thereby created were further exacerbated by the rapid increase in most prices as the price discipline of the pegged exchange rate needed to be abandoned.

In addition, even when the basic logic for financial market liberalisation is impeccable, the transition difficulties for both financial and labour markets may be acute especially if liberalisation occurs after lengthy periods of financial repression and high or seriously repressed inflation (see also Annex 2 on Financial Markets). Damagingly high real interest rates in that transition period are likely to have severe negative effects on the employment and living standards of poorer workers.

As regards labour markets themselves, the increasing integration of international capital and product markets contrasts markedly with the international market for labour (especially unskilled labour). The latter is notable for the degree to which it is poorly integrated. The international labour market is characterised by a high degree of segmentation – skilled labour for example being far more mobile than unskilled – and by ubiquitous national government regulation of immigration. There is currently an active debate about the benefits to low income countries of allowing significant outward migration of their specialist skilled labour while unskilled labour remains heavily restricted. At first glance this type of development must lead to short term losses of growth potential for the low-income countries and probably to indirect damage to poorer households in those communities. But this is not a proven proposition since large-scale international remittances and other mechanisms could serve to mitigate such effects.

Another very important component in the current debate regarding labour markets and globalisation is that relating to possible core labour standards. The basic objectives underlying the advocacy of such standards are universally accepted. They include the elimination of forced labour and slavery; the abolition of the exploitative forms of child labour; the elimination of many forms of labour discrimination based on ethnicity, gender etc., and the establishment of humane working conditions for all. However, the methods whereby such standards are internationalised and the precise institutional arrangements put in place can critically determine whether these constraints on markets work to improve or worsen the lot of the poorest families. In almost all cases – child labour, collective bargaining rights, non-discrimination in wages – there are invariably adverse effects for the poor that can arise as well as the expected beneficial results.[6] The imperative to attract international capital has encouraged national governments to adopt investor (and employment) friendly policies, that contribute to a stable macro-economic environment and do not increase

[6] Examples include the diversion of child labourers into illegal and even more harmful occupations such as prostitution when their employment in legal activities is prohibited; the forcing of some families into destitution when children are forced to extend the length of their schooling rather than seek paid employment; and the loss of trade competitiveness and jobs when labour higher labour standards are adopted.

the price of labour. Set against this is the concern that governments may be reluctant to introduce and enforce basic rights for workers.

Past interventions and lessons learned

Demand for the labour of the poor, being substantially derived from the demand for the goods and services they produce, is intimately linked to the performance of the wider economy. The labour market is also closely bound up with other factor markets on whose performance it depends. The labour market's poverty-reducing effects are therefore not separable from the effectiveness of measures to improve the wider economy and to strengthen pro-poor growth patterns. Government interventions affect the workings of the labour market in many different ways. These include:

- the often unintended effects on the incentives for labour market segmentation and the capacity of the informal sector to absorb labour;

- the indirect effects of actions directed at markets related to labour;

- the effects via labour market-support institutions.

- The distribution of public goods of direct relevance to human capital enhancement

Incentive structures

Minimum wage legislation, if effectively enforced, may benefit the individuals directly concerned, but there is a risk of undesirable side effects. These are well documented for rich and poor countries and can include significant reductions in employment in those sectors where the legislation is enforced; changes in employment patterns with, for example, younger and less experienced workers losing ground; distortions as non-regulated labour is substituted for the more expensive regulated variety; and other spillover effects on sectors where the legislation is not applied.

Both theory and international experience suggests that the adverse employment consequences of tight fiscal policy and trade liberalisation are less severe when accompanied by greater labour market flexibility. But there are several cases where stabilisation and adjustment programmes have been accompanied by policy measures that have served to increase rather than reduce labour market rigidities and harm the incentives for employment.[7] While the motives behind this are entirely understandable, the consequences for the incomes of poorer workers may nonetheless be damaging. Similar comments apply to official efforts to bring more of the so-called

[7] In South Africa's case, demand constraining fiscal and monetary policies and tariff reductions have been accompanied by new protective labour market legislation and the extension of minimum wage coverage across the country. In 1996, the government extended minimum wages to the old homeland regions, where a low wage environment had previously encouraged very low cost labour-intensive clothing firms to locate. Many of these firms responded by shutting down operations and relocating in neighbouring countries. The result has been that some of South Africa's poorest regions have experienced a net decline in employment, so impoverishing them even further. (Nattrass 2000).

informal sector under tighter regulation in order to enhance the welfare of the workers engaged therein. The dilemma facing the authorities is also a difficult one in this case. This is because, in many developing countries the informal sector is not subjected to consistent regulation. Instead it often experiences regular, probably corruptly-motivated harassment from the authorities. This increases costs and risks and acts as a disincentive for the informal sector to maximise its absorption of labour. In these cases, official actions to formalise the sector are at best ambiguous as regards incentives and the welfare of poorer workers.

If public sector pay levels are significantly out of line with market rates this will give rise to a misallocation of resources. If public sector pay is too high then it will result in government attracting and retaining the country's most able workers to the detriment of the private sector. If it is too low then it may result in low standards of public sector service delivery and resource allocation, as well as rent seeking behaviour by government employees. Certainly, in many developing countries, the state sets a standard of remuneration which can impact some other branches of employment. In too many cases, the state also plays the role as a reservoir to absorb significant quantities of surplus urban labour at low rates of pay. In general, the state can play its role better if its reforms itself with a smaller but far more productive and well-remunerated civil service.

Labour migration has a critical role to play in the diversification of livelihoods. Nevertheless, some countries have sought to control the extent of domestic (inter-regional) labour migration, so exacerbating the extent of labour market segmentation, and reducing the livelihood strategies open to the poor. Others have sought to facilitate the temporary exportation of migrant labour to neighbouring countries or overseas, with positive effects on the ability of governments to manage macro-economic reforms (e.g. in Bangladesh). In a number of cases, the income transfers from relatively well-paid migrants (to urban jobs or to abroad) have played a critical role in financing productivity-raising investments in traditional agriculture (e.g. migrants to Nairobi from the Central Province of Kenya) and, more frequently, in directly raising incomes of family members who stay behind.

Interventions in related markets

In many developing countries, various combinations of different instruments such as export taxes, quantitative export controls and over-valued exchange rates have all resulted in a bias against the tradeable (and especially agricultural) sectors, and therefore those people who work, or might otherwise work in those sectors. The cocoa sector in Ghana in the 1970s is one egregious example of how seriously these interventions can tax the labour and other inputs of workers in the sectors of a country’s comparative advantage. Numerous other examples are to be found in the extensive literature on trade and related reforms of the past 20 years.

All over the world there are examples of government interventions which have, however unwittingly, subsidised the use of (often scarce) capital instead of labour. The workings of the Food Self Sufficiency Programme in Lesotho during the 1980s and early 1990s provides one example (see Annex 5).

Labour market support institutions

Some forms of labour market institution are unambiguously desirable and beneficial to most categories of labour including the poorer amongst them. This is true, for example, of labour exchanges and other similar organisation that can provide information and networks of mutual support in finding work. It is true also of retraining activities for retrenched workers. All these public goods serve to enhance the flexibility for labour markets and increase their ability to respond smoothly to economic shocks. Policy prohibitions applied to labour markets can also play a role in reducing some of the imperfections on those markets. For example, prohibitions on ethnic and gender discrimination in employment should work in this manner. Prohibitions of child exploitation in labour markets falls into the same category.

More difficult are those policy interventions in labour markets which direct benefits at one sub-set of workers and which can have negative side effects for other sub-sets. The promotion of trades unions is an obvious example. The activities of trades unions can inhibit and even block important structural reforms, and result in improved pay and conditions for unionised labour at the expense of entrepreneurs, consumers, and non-unionised labour. However, there is also widespread recognition of the positive role that can be played by organised labour. Trades unions balance the power of employers, may contribute to improved productivity and work place safety, and oppose discriminatory employment practices. Similar comments apply to the adoption by developing countries of factory and other similar standards of benefit to workers of the type advocated by the ILO. These interventions will typically enhance the welfare of some group of workers while creating some undesirable side-effects for workers in informal employment. The issue here is not whether these actions are desirable – clearly they are. The dilemma for policy is how quickly they can be adopted in any particular circumstance

Public goods - a source of help to enhance the value of human capital

The introduction to this Annex noted the important role in labour market performance played potentially by pro-poor public expenditures in areas such as education and health provision as well as in supporting infrastructure such as transport. Social expenditures in these areas, if targeted explicitly on poorer families can have a significant impact on the ability of poorer workers to participate more effectively in labour markets. Additionally, specific subsidies to the nutrition of poorer families will enhance that participation and lessen involuntary employment by achieving marginal increases in productivity. The policy agenda in many developing countries is to seek far greater efficiency in the provision of these public goods. This should increasingly enlist market mechanisms to deliver education and health services to those who are better able to pay for these. This would then enable a greater part of scarce public resources to be allocated to poorer households and workers thereby giving them improved opportunities to participate effectively in labour markets and with higher levels of remuneration.

Future approaches of governments and donor agencies

Government initiatives to improve macro-economic stability, policy coherence and credibility, and initiatives to introduce policies that strengthen the efficient operation of markets (such as reducing transaction costs - legal, information etc) may encourage positive impacts of globalisation on the operation of labour markets. Governments need to regularly review all their policies and programmes to ensure that they are not encouraging the substitution of capital for labour, whether directly or indirectly.

Donors also need to be consistent in their approach, and support developing countries in processes that affect the global governance of international factor and product markets. They need to embrace the need for their own economies to reform and adjust, in particular those sectors (such as agriculture and textiles) producing labour intensive products.

At the same time donor governments need to be forthright in contradicting some of the messages presented by elements of civil society that threaten the livelihoods of the world's poor. NGOs can play a valuable role in publicising some of the negative effects of globalisation. However, some campaigns may be counter-productive, and may play into the hands of domestic vested interests.

Annex 4

Land Markets

I. Introduction

Access to land, and the conditions and security of that access, critically affect the livelihoods of many of the world's poorest households. Households with land are generally better placed to make productive use of their own resources (especially labour), as well as to attract outside capital and labour, and to build social capital. Household production or gathering of agricultural commodities for subsistence or sale may constitute the household's central livelihood strategy or supplement livelihoods generated by other activities. As a result, the uneven distribution of land in many parts of Asia, Latin America, and Southern Africa is a particular cause for concern.

This annex considers how access to land by the poor may be assisted or compromised by the way that markets operate, and the potential influence of actions by governments and donors. Using the framework set out in the main body of the discussion paper, section II considers different systems of land allocation, and section III considers some of the lessons of interventions in land markets by governments around the world. Section IV considers approaches for governments and donors that are most likely to improve access to land for the poor.

II. Markets and Land Access

This section considers three broad sets of processes by which the poor may access land. It concentrates on the extent to which such processes are economically efficient (and in particular the scope that exists for market failures), and the extent to which they facilitate the participation of the poor.

Customary land tenure

Adams (1997) identifies three broad categories of African customary land tenure arrangements:

- Land holdings, where individuals or households have relatively exclusive rights of use, based on customary rights;
- Common land, where the use rights are shared between multiple users. Such land is generally either managed as a common property resource or is open access; and
- Reserves, where use may be prohibited by the group (e.g. dry season grazing reserves).

Customary land tenure arrangements are often characterised as leading to a relatively equitable distribution of land but as being relatively inefficient. However, whether this is indeed the case in practice often depends upon the exact context and the precise nature of governance arrangements, and associated conditions of use.

- How far does population pressure restrict the amount of land available per household?
- How much discretion do traditional authorities have to allocate or withdraw use rights, and how accountable are they to all local people for the way that any discretion is exercised?
- In particular, what criteria are used when making a new allocation or reallocation of land?
- What constraints exist for customary rights to be inherited by the family of the deceased?
- Can women hold land in their own right?
- How far are individuals or households at liberty to delegate use rights through rental or sharecropping arrangements?

The answers to such questions will not only determine the opportunities for the poor to access land, and the security of such access. They will also affect matters such as the incentives for households to invest resources in improving the productivity of their land, and the incentives for taking action to avoid environmental damage.

Land ownership.

Where the right to use land is determined by the individual who owns the freehold on land rather than traditional authorities, who has access to land will tend to depend upon who offers the best terms for purchasing or renting land. In such circumstances equity considerations are much less prominent. Although in theory, this may suggest that the allocation of land access becomes more efficient, this may not necessarily be the case. It is often argued that there exists an inverse relationship between the size and the efficiency of farming operations. Lower labour and management costs are the main sources of advantages to small-scale producers, although in any given situation they may have to be weighed against economies of scale associated with accessing information, managing risk, and the indivisibility of capital inputs.

Where individual land ownership systems prevail, it is frequently observed that land holdings tend to consolidate rather than fragment. This either means that larger landholdings are relatively more efficient than many economists have recognised, or that concentration in the land market arises from distortions in the land market and other related markets. Examples may include the following.

- For various reasons, the market price of land may exceed its productive value (e.g. because land is used as a hedge against inflation, because there is speculation that it may be converted to urban use, or because of the impact of subsidies and tax incentives).
- Fixed transaction costs may make the sale of land to one buyer more attractive than to many.
- Imperfect capital markets may mean that the poor (especially poor women) are unable to afford land, or are more prone to distress sales (e.g. during drought), so allowing capital rich households to accumulate land when the price low. Once sold, land is then difficult to reacquire.

Land rental and sharecropping

However unfair and inefficient the distribution of land ownership or use rights, and the processes by which such distribution comes about, an active land rental market or strong tradition of sharecropping may go a significant way to improving both the efficiency of land use and the quality of opportunities available to the poor. Nevertheless rental markets have often had a low profile in the consideration of land markets and land access.

In principle a well-functioning land rental market can exist whether land use rights are based on a customary or freehold system (although the extent of formality may differ). Compared to land purchases, accessing land through rental arrangements will generally involve:

- Lower transaction costs;
- Greater flexibility;
- Reduced reliance on (often distorted) capital markets;
- Reduced exposure to the costs and risks of acquiring land where the price may be determined by factors other than its productive value; whilst allowing
- Lessors and lessees to benefit without the permanent alienating of the land.

Sharecropping arrangements provide an alternative to land rental, although they generally involve some sort of payment in kind for access to land. They facilitate risk sharing and access to capital in the context of distorted financial markets, and allow the building of social capital. Again though, the precise effect of land rental and sharecropping on the poor (and their efficiency) depends upon the exact terms of the arrangement.

III. Past record of government intervention in land markets

Notwithstanding the important link between land and poverty, poverty is usually only one of a number of reasons cited by those proposing government intervention in land markets. Other reasons include a determination to right historical wrongs, and a belief that land reform will lead to improved agricultural productivity and efficiency. El Ghonemy (1990; 1994) and Tyler et al (1993) (both cited in Toulmin and Quan (2000) present evidence suggesting a link between reduced concentration of land holdings and faster poverty reduction for any given level of agricultural growth.

Governments have employed a wide range of mechanisms to intervene in the operation of land markets. These interventions often have a relatively narrow focus, concentrating on issues of ownership, rather than the broader (and arguably much more important) issues relating to ease of access and the efficiency of allocation. Adams (1997) categorises these interventions as follows.

- *Imposed redistributive reforms* are effected through the law affecting property rights in a variety of ways (e.g. nationalisation, restitution, and the reallocation of land expropriated on the basis of the large size of the initial land holding,

low utilisation, or the status of the owner). Taxation policy (death duties and land taxes) have a similar effect, albeit more gradual.

- *Induced redistributive reforms* (market based) whereby the government participates in the land market (through the sale or distribution of pre-existing public land, or land acquired for the purpose) and takes other initiatives (provision of advice and establishment of support structures) in support of beneficiaries.

- *Land tenure reform* whereby the government changes the legal relationship between those who control land allocation and utilisation, and those who work the land (whether landlord and tenant, or chief and villager).

- *Confirmation of title* in terms of which those with a demonstrable claim to land have this claim made more secure and explicit, with a view to encouraging greater confidence and investment.

Following Quan (in Toulmin and Quan 2000), international experience shows that land reform can contribute to economic growth and poverty alleviation given the appropriate conditions. Poverty alleviation has to be an explicit and genuine motivation for a sustained (10 years or more) programme of land reform that makes provision for the necessary support services (in particular marketing). The design and implementation of such a programme must be informed by the perspectives of the intended beneficiaries, and must be sufficiently flexible to allow for institutional learning. However, at the same time, badly designed and implemented land reform programmes are not merely likely to fail, they may well aggravate the situation of the poor. For example they may make tenure less secure, and allow richer sections of the community to acquire control over land and associated resources.

Experience with redistributive reforms

Arguably some of the most successful land reforms occurred in South East Asia in the immediate aftermath of World War II. These reforms were comprehensive, creating a class of property-owning peasants, and had a positive impact on poverty and landlessness, although, at least in part, their success can be attributed to the exceptional circumstances prevailing in much of the region at the time. Commentators (e.g. Adams 1997) also regard the resettlement schemes implemented in Kenya and Zimbabwe soon after Independence as being moderately successful. The outcomes of these initiatives were positive: for those acquiring land as well as those leaving it; for the macro-economy; and because large-scale capital-intensive farming systems were converted into sustainable labour-intensive, small-scale mixed farms. Resettlement schemes in Latin America have been much less successful and highlight the sorts of (often inter-related) difficulties that can be expected from such initiatives. Examples include political interference all the way through the process (from expropriation and compensation to land allocation), problems in agreeing definitions of key concepts (e.g. under-utilisation) considerable delays in the allocation of land, and a lack of consultation with intended beneficiaries.

In countries (such as South Africa) where there is an active land market government can influence the distribution of land by participating as a buyer in the land market before passing on such land to land reform beneficiaries.

Experience with land tenure reform

Tenure reform normally refers to changes to the terms of tenure of customary land and takes place against the backdrop of a (sometimes intense) debate between those who favour traditional tenure systems, and those who argue for western-style systems that are based on the concept of individual ownership. The latter focus on the sustainable use of land, and take a view that increased investment, productivity and development requires the individualisation of land tenure arrangements. The former group emphasise the way that customary tenure arrangements are integrated into the social, political and economic fabric of developing countries, and argue that customary arrangements are in any event able to adapt in the face of demographic and economic pressures. Indeed, Adams (1997) argues that the introduction of individual titles on formally customary land (titling) has in practice led to an increasing landlessness and skewed land distribution, without necessarily increasing agricultural investment and productivity.

IV. Future approaches of governments and donor agencies.

Alternative approaches for government

With a view to promoting more efficient land use and more equitable access to land Quan (2000) proposes that government intervention in land markets should concentrate on the following.

- Customary tenure systems should be recognised by, and integrated into, the legislative framework, with land registered in the name of communities.

- Tenants rights should be extended, and initiatives taken to encourage the development of rental markets.

- Women's rights and access to land should be promoted, in particular through the reform of inheritance laws.

- Governments should facilitate the management of natural resources at the community level.

- Governments should promote the participation of stakeholders in the development of land policy.

The role of donors

Land market development can be an intensely political process which in practice can limit the involvement of donors. However, circumstances do arise, generally following a political change, in which donors are invited to contribute broad changes. More commonly, the shortage of funding and expertise affecting many governments and NGOs can give donors an important role at a technical level, including in cadastral survey and titling, and in institutional development, for instance in strengthening local organisations and processes such as the operations of district land boards.

Donors will also commonly be invited to assist in strengthening services that are complementary to land markets, such as improving rural infrastructure or agricultural technical services. Support for community organisations that empower the poor to improve their terms of access to land markets, or make better use of land which they own or rent, or on which they sharecrop, may also provide opportunities for donors to support pro-poor land markets.

Annex 5

Staple Food Marketing: Maize in Lesotho

Introduction

Staple food markets are of fundamental importance for economic development, political stability, and the welfare of the poor. The poor spend a high proportion of their disposable income on staple foods, whilst the production, processing and marketing of staple foods are (at least potentially) important sources of livelihoods for the poor. The efficiency of the food marketing system also has implications for the macro-economy, through its effects on the rate at which urbanisation, industrialisation and agricultural specialisation can occur, as well as the level of real wages.

In most parts of southern Africa, white maize is both the most important staple food, as well as being the most important arable crop in terms of area planted.[1] The ways in which the region's maize production and marketing systems are organised play a very important role in determining the food security position of the poor, and the livelihoods opportunities available to the poor, both directly, and indirectly through their impact on the different asset bases available to the poor. This annex first considers the international experience with state involvement in, and (often only partial) withdrawal from, the pricing and marketing of staple foods, with particular reference to southern and eastern Africa. Then, against this backdrop, a number of important points are illustrated by examining the influence on the poor of government policies and programmes affecting the production and marketing of maize in Lesotho during the first half of the 1990s. In particular the Lesotho example shows how intervention by the state (especially where the distribution of land is uneven, and where the majority of households are structural net purchasers of maize whether they are producers of maize or not) can, however inadvertently:

- Effect welfare transfers from the poorest households to those with greatest access to land in the name of self sufficiency (through higher maize prices);
- Generate considerable inefficiencies (because of inflated transport costs);
- Weaken the asset base available to the poor (in this case the trading network, and the environment); and
- Disadvantage labour intensive technologies (such as hammer mills and animal draft power).

International experience with government intervention in staple food markets

Many countries have intervened in staple food markets in an effort to achieve one or more of the following: a reduced risk of famine; a reduced level of import

[1] For ease of exposition, all references to maize in this paper mean white maize, unless otherwise specified.

dependence; cheap and stable consumer prices; higher and stable producer prices; efficient and non-exploitative marketing systems. The various instruments employed by governments resulted in high marketing costs, wide margins between producer and consumer prices, significant welfare transfers between producers and consumers, reduced opportunities for labour intensive processing and marketing, and significant costs to the fiscus.

Widespread liberalisation and deregulation have been driven by Ministries of Finance during the 1980s and 1990s, prompted by conditions imposed by donors because of high fiscal costs in the context of macro-economic stress. In eastern and southern Africa, reform has been subject to frequent policy reversals and has been partial, with continued significant intervention by the state in trade and through the operation of strategic grain reserves. The notable exception is South Africa, where the final set of agricultural marketing reforms were comprehensive, and their impetus came from domestic political reform.

The results of reform to date have included a significant reduction in marketing and processing margins, a wider range of products on the market, and a reduction in the fiscal costs of the system. The benefits of efficiency gains have generally accrued to consumers and a limited number of well-situated producers, although price instability has increased for both producers and consumers. Liberalisation does not appear to have boosted grain production.

A number of issues face policy makers throughout sub-Saharan Africa. First, how to contain the effect of price instability on producers and consumers without inflating marketing margins and incurring fiscal costs.[2] Second, how to boost small-holder productivity, especially where smallholder credit and input supply systems have broken down. Third, how to encourage the growth and deepening of small-scale trading and processing enterprises. Finally, how to move to greater regional integration whilst governments are unwilling to relinquish their capacity to intervene in domestic food markets. An emphasis on policy consistency and coherence, infrastructural development, and initiatives to strengthen the capacity of the private sector are likely to be important components of successful agricultural marketing strategies in the future.

Maize Production and Marketing in Lesotho in the early 1990s

Background

Lesotho is a small country totally land-locked by the Republic of South Africa. Its lowlands are in the north and west of the country (bordering the Free State) with the land becoming steadily more mountainous as one moves east towards the escarpment that forms the border with Kwazulu-Natal. Lesotho has for a long time been a labour reserve for the South African economy, with remittances from migrant labour

[2] Only in South Africa, with its highly developed financial system, a large-scale private sector, and the complete withdrawal of the state from marketing, have new institutions that provide for the management of price risk emerged. Such developments have potentially positive implications for other countries in the region provided that appropriate policies are adopted.

accounting for a significant proportion of income at the national and household levels. Notwithstanding its quite distinct legal status, Lesotho's socio-economic situation in the early 1990s was in many respects similar to that of a number of the homeland areas of South Africa.

Although in theory Lesotho's traditional land tenure system was meant to guarantee all households access to arable land, in practice land allocation was uneven. It is estimated that in the early 1990s approximately one third of households were landless.

Lesotho's network of trading stores supplied a wide range of food and other consumer goods, as well as agricultural inputs, sometimes sold on credit, most of which were manufactured in South Africa, and many of which were purchased using remittances from relatives working in Lesotho's urban areas or in South Africa. This rural trading network was dominated by Lesotho's small non-indigenous population. Most villages also had one or more increasingly aged hammer mills, often located next to the trading store, providing custom milling services. Lesotho also had three large industrial mills in the early 1990s, all of which were situated close to the South African border.

Although susceptible to drought and frost, maize was produced in most areas of Lesotho. Maize yields and production per household vary by area, and with climatic conditions, but even in the very best years, Lesotho is a net importer of maize from South Africa. It is estimated that less than 10% of households produced sufficient maize in the early 1990s to meet household requirements[3].

If Lesotho's rural households were unable to grow sufficient maize to meet their own consumption requirements, they either had to buy maize from a neighbour and process it at home or at a hammer mill, or they had to buy whole maize or maize meal in the local store. Given Lesotho's position as a structural importer of maize, and given that the majority of households were net purchasers of maize, the value of maize to the household was closely related to the cost of buying imported South African maize (import parity) in whatever form it was available.

South African maize marketing policy

In the early 1990s all producers in the main South African commercial production areas were obliged to sell their surplus maize to the Maize Board, and received the same price where ever they were located. The Maize Board's administrative costs, and the costs of storing and financing the maize crop were covered by a levy on sales into the domestic market and to the BNLS countries.[4] In years of maize surpluses a stabilisation levy was also collected on such sales, and used to subsidise maize

[3] Other staple crops included sorghum (especially in the drier south and west) and wheat (grown as a staple in some foothill and mountain areas). Marijuana was grown as a cash crop, particularly in the more remote foothill and mountain areas. Although its production was illegal, and accurate figures were hard to come by, anecdotal evidence suggested that the production and marketing of marijuana was an important source of income for a significant number of households.

[4] Botswana, Namibia, Lesotho, and Swaziland, all of which were, together with South Africa, members of the Southern African Customs Union (SACU).

exports. The result was that the higher the South African harvest (and therefore the exportable surplus of maize), the bigger was the gap between the Maize Board's domestic buying and selling prices, and the higher that local prices were above export parity.

In determining its net exportable surplus, the Maize Board took account of Lesotho's likely import requirements. However, as with the other members of SACU, the Maize Board only issued permits for the exportation of maize to Lesotho when the applicant could produce an import permit issued by the Lesotho Government. The Maize Board often allocated maize from South Africa's more remote production areas for export to Lesotho. This implied significant additional transport costs compared to the situation that would have prevailed if Lesotho importers had been allowed to buy some of the significant quantities of maize that was produced close to Lesotho's northern and eastern borders.

Hence South African maize marketing policy inflated the cost of importing maize into Lesotho in two ways: through the collection of a stabilisation levy to subsidise exports out of the region; and because of the way it allocated maize to Lesotho buyers.

Lesotho Government policy and maize

The Government of Lesotho intervened in the production and marketing of maize and maize meal in a number of ways.

- Until the early 1990s a parastatal (Co-op Lesotho) had a monopoly on the sale of seed and fertiliser in Lesotho.

- The Ministry of Agriculture operated the Food Self Sufficiency Programme (FSSP) until 1993. Under the FSSP the government organised the ploughing and planting of arable land (mainly to maize) using tractors. The provision of tractor services, seed and fertiliser were funded by loans from the Lesotho Agricultural Development Bank (LADB) and Lesotho Bank, which the farmers were supposed to repay after harvest. However, the repayment rates for FSSP loans were very low. For example, Lesotho Bank reported in 1992 that in the 1990/91 production season only 7.8% of the money it lent under the FSSP was repaid[5].

- The Ministry of Agriculture controlled the importation of maize and maize products into Lesotho through the restrictive issuing of import permits[6]. In the

[5] Government officials placed significant emphasis on the need for Lesotho to be as economically independent of South Africa as possible as a justification for the FSSP. However, the degree to which the Lesotho economy was integrated with the South African economy meant that any such benefit was marginal. Lesotho was dependent on a consistent flow of remittances and a whole range of imported South African products (such as petrol, electricity, all basic foodstuffs etc).

[6] As was also the case with wheat, wheat products, eggs, milk and sugar.

1992/93 marketing year, 97% of maize imports were authorised by permits issued to the big three industrial mills[7].

- The government gazetted official mill-gate selling prices of maize products, and mill-gate purchase prices for maize delivered by Basotho farmers to the industrial mills[8].

The impact of Lesotho Government Policy.

Lesotho government policy in respect of maize production and marketing benefited the better-off sections of Lesotho society, particularly those with access to significant areas of land. *First*, any benefit from the implicit maize production subsidy (to the extent that farmers did not repay their loans) available under the FSSP was proportionate to the amount of a household's land serviced by the FSSP. *Second*, as a result of the import restrictions on maize and maize meal, any maize surplus produced by a household could be sold for a significantly higher price than would otherwise have been the case. *Third*, the large mills (one of which was owned by the government), benefited from guaranteed markets for their products and guaranteed margins.

By contrast, the effect on Lesotho's poorest citizens was both substantial and negative. In short, policies weakened the asset base available to the poor, made it more difficult for the poor to generate livelihoods from their asset base, and reduced the real value of income streams otherwise generated by the poor by unnecessarily inflating nominal maize meal prices.

- Although poor households whose land was cultivated under the FSSP would have benefited from a welfare transfer (to the extent that they did not repay their loan), FSSP was not a targeted anti-poverty programme. Indeed, its operating procedures favoured those whose fields were more than 1.5 acres and who were recommended as being creditworthy by the village chief.

- Lesotho's maize policies added another layer of costs to households which were net purchasers of maize. Over and above the higher cost of maize imports resulting from the South African Maize Board's policies, maize meal prices were inflated because government managed maize imports in such a way that transport and processing costs within Lesotho were inflated. Virtually all (97%) imported maize was processed with an unnecessarily expensive technology (compared, for example, to hammer milling) and had to make its way to the final consumer via towns on the northern border with

[7] Although the Ministry of Agriculture claimed that it had relaxed its longstanding policy of restricting the issue of import permits, this decision was not publicised and traders were highly sceptical that any policy change had in fact occurred.

[8] There was considerable emphasis on the desirability of Lesotho having its own modern industrial mills as a market for Lesotho maize. However, in reality, the large mills considered deliveries of local maize to be something of a nuisance because of the relatively high unit transaction costs implied in grading and paying for small batches, and arguments over quality. In reality the industrial mills were most profitable when the Lesotho harvest was small, deliveries by Basotho farmers low, and the residual domestic demand for maize meal relatively high.

South Africa, even if the consumer lived on the border with South Africa on the other side of the country. The FSSP did increase the availability of maize inside Lesotho. However, it merely served to delay the point at which the majority of the country was dependent on maize imported via the industrial mills (arguably by little more than a matter of weeks in most marketing years).

- To the extent that policy inflated maize meal prices, the incentive for net purchasing households to grow their own maize, rather than purchase whole maize or maize meal, was increased. This increased the vulnerability of households to drought and frost, and encouraged them to grow maize on poor soils and slopes that were vulnerable to erosion. This problem increased the further one went into the foothills and mountains and away from the northern lowlands where the industrial mills were situated, even as one approached the South African border, the other side of which maize meal was on sale for significantly lower prices.

- Given Lesotho's dependence on imported products, and the relative geographical isolation of many communities, the network of trading stores was a valuable part of the infrastructure, especially to the extent that credit was advanced. Coop Lesotho was an attempt to provide a substitute for non-indigenous trading networks. However, to the extent that it enjoyed a legal monopoly on goods such as agricultural inputs, it threatened to undermine the viability of the rest of the network, even though it became renowned for failing to supply seeds and fertiliser in time for planting.

- Government policy reduced the opportunities for the poor to generate their livelihoods from agriculture and related activities. Because almost all imported maize went to the industrial mills, the demand for custom milling at the hammer mills dried up with the supply of locally produced maize, so reducing employment possibilities for the rural poor. The FSSP substituted for sharecropping arrangements that might otherwise have provided the poor with opportunities to generate a livelihood. Although some privately owned Lesotho tractors were used by the FSSP, the majority of tractors and tractor drivers used by the Ministry of Agriculture were either owned and employed by the Ministry itself, or by South African farmers. All of these factors reduced the investment opportunities for potential local entrepreneurs (e.g. men who had returned from the mines or farms of SA with improved skills and possibly some savings), and the employment opportunities that would otherwise have emerged.

- Poor credit discipline under the FSSP merely served to reinforce the poor repayment record of government sponsored agricultural credit schemes, which in turn undermined the development of rural financial markets.

Implications of South Africa's agricultural marketing reforms.

Subsequent changes in South Africa have changed the policy choices facing the Government of Lesotho. The Maize Board has been closed down, export subsidies

have been terminated, and restrictions on who is able to buy and sell maize, and the price at which they may do so, have been removed. Vibrant markets in maize futures and maize options have emerged in response to the significant inter- and intra-seasonal price variability.

This has a number of implications for Lesotho.

- Although the price of maize varies with its location, and will tend to be more expensive in the eastern Free State than in North West Province, Lesotho importers are now free to buy maize from those areas of South Africa which imply the lowest landed price of maize at mill-gate.
- Mill-gate prices for Lesotho producers of maize would have to vary every day if they were to reflect import parity from South Africa.
- Any attempt to control maize imports and smuggling into Lesotho is that much more difficult in the absence of the South African Maize Board.

In spite of the changes in South Africa's marketing system, the Government of Lesotho's policy will still be a very significant influence on the price at which maize meal reaches Basotho households.

Conclusion

Although a government may commit itself to an anti-poverty strategy, local elites may have very significant interests in opposing the very initiatives which are most likely to have a sustainable impact on poverty. Lesotho government policy in respect of maize production and marketing, in the early 1990s, shows how domestic government policy may combine with exogenous factors to erode the asset base of the poor, and to reduce the scope for the poor to generate livelihoods from the asset base to which they do have access. It also shows how the risks faced by the poor may be increased, whilst the real value of the livelihood strategies that the poor pursue is reduced.

Selected Annotated References and Bibliography

Annotated references

There is a large literature on almost all subjects covered by this framework paper. Those wishing to explore further, may find the following useful.

The World Bank's 'Assessing Aid', as critiqued by J. Beynon (1999), explores the poverty impact of aid, concluding that aid only really works when government policies are good. D. Dollar and A. Kraay (2000), which has been extensively debated since, examines growth and poverty, concluding that low-income groups in aggregate benefit in a one-to-one ratio with overall rates of growth.

The nature of markets as institutions is developed by North (1989) in a classic of institutional economics, with a useful update of theory and practice provided by Williamson (2000).

Market failures are discussed by Atkinson and Stiglitz (1980).

Vulnerability and the importance of different types of assets are set out in a livelihoods context in DFID's Sustainable Livelihoods guidance sheets (section 2), and the associated website.

In relation to specific markets, financial markets and the poor are reviewed by Hulme and Mosley (1996), while sobering lessons of some past interventions in Africa are examined by Brownbridge and Harvey (1998).

Labour markets are overall explored by DFID's 'New Economist Guide', with a large amount of material on labour markets, poverty and policy presented in Horton, Kanbur and Mazumdar, eds. (1994)

Adams (1997) is a good brief starting point on land issues and poverty, with many aspects explored further by Toulmin and Quan (2000)

Theory of food markets is developed by Shaffer (1980), while the literature is reviewed and experiences with reform are set out by Jones (1996) and (1998).

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