

CHAPTER 4

Making Markets Work Better for Poor People

Markets matter for the poor because poor people rely on formal and informal markets to sell their labor and products, to finance investment, and to insure against risks. Well-functioning markets are important in generating growth and expanding opportunities for poor people. That is why market-friendly reforms have been promoted by international donors and by developing country governments, especially those democratically elected.¹

But to develop markets and the institutions that support them is difficult and takes time. At times, reforms to build markets fail entirely. When they succeed, they frequently impose costs on specific groups in society. When the losers from reforms include poor people, who are particularly vulnerable to shocks, countries have a special obligation to ease the burden of reform. And even when markets work, societies have to help poor people overcome the obstacles that prevent them from freely and fairly participating in markets.

In the 1950s and 1960s many of those shaping policy believed that economic development and poverty

reduction required active participation of the state and protection of local industry. This inward-looking, state-led development path was adopted by a wide array of countries throughout the world, with varying degrees of success. Many countries adopted protectionism, government control of investment, and state monopolies in key sectors. In countries such as India this strategy resulted in persistently slow growth. In other countries, particularly in Latin America, this strategy initially delivered strong growth through the 1960s, but growth eventually faltered as countries were buffeted by oil shocks in the 1970s and the debt crisis of the 1980s. And in China in the late 1970s there was a gradual realization that the economy, especially the agricultural sector, had not realized its full potential under heavy state control.

The increasing disenchantment with inward-looking, state-led development led national governments to implement reforms that replaced state intervention in markets with private incentives, public ownership with private ownership, and protection

of domestic industries with competition from foreign producers and investors.² Where such market-friendly reforms have been successfully implemented, on average economic stagnation has ended and growth has resumed.

But in some cases reforms were not successfully implemented, often with particularly severe consequences for poor people. The broad diversity of failed reforms does not lend itself to easy generalization.³ Some reforms proceeded too quickly and failed for want of supporting institutions. Others proceeded too slowly and were captured and undermined by special interests. Yet others were imposed by government elites and foreign donors and foundered for lack of strong domestic leadership and a broad-based commitment to reform.⁴

The debate about reforms is therefore not over a choice between reforms or no reforms: the absence of reforms to develop vibrant, competitive markets and create strong institutions condemns countries to continued stagnation and decline. Nor is the debate over a simplistic dichotomy between gradualism and shock therapy: reforms can proceed either too quickly or too slowly to succeed. Rather, the debate is on how reforms to build markets can be designed and implemented in a way that is measured and tailored to the economic, social, and political circumstances of a country.⁵

Inevitably, market-oriented reforms have different effects on different segments of society. Every reform program has its winners and losers, and poor people may be found in either group. The particular vulnerability of poor people demands a careful assessment of the likely poverty impact and the implementation of appropriate compensating policies.⁶ It also calls for careful consideration of the pace of reforms in the light of the likely effects on poor people. Experience shows that direct dialogue with poor people can be particularly effective in informing this process.

Even when markets function, they do not always serve poor people as well as they could. Physical access to markets can be difficult for poor people living in remote areas. Regulatory barriers often stifle economic activity in sectors and regions where poor people are likely to seek jobs. And access to some markets, especially for financial services, can be difficult for poor people since they often engage in small transactions, which traditional market participants find unprofitable or insignificant. Investments in infrastructure, lighter regulatory burdens, and innovative approaches to improving access to financial markets can therefore do much to ensure that the benefits of markets are shared by poor people.

This chapter addresses these issues in turn. It first considers the widely varying experience of countries that implemented market-oriented reforms over the past 20 years, highlighting both success stories and the severe consequences of failed reforms. It then illustrates the complex effects that market reforms have on poor people, with examples from three areas: agriculture, fiscal policy, and trade. Last, it discusses how lightening the regulatory burden, promoting core labor standards, and expanding microfinance can be beneficial in improving the terms on which poor people participate in markets.

Have market reforms delivered growth?

In the 1980s and 1990s much of the developing world moved toward implementing market-friendly reforms. The motivation for reforms and their scope and pace varied widely. In China, for example, the “household responsibility system” replaced communal farming and created new incentives for rural households to produce, invest, and innovate. These reforms were provoked neither by macroeconomic crisis nor by ideological epiphany; rather, they reflected a growing realization that China’s agricultural potential was not being fulfilled. These initial agricultural reforms were followed by the introduction of market mechanisms throughout the economy. In other countries macroeconomic crises provided the catalyst for reform: in Mexico, for example, the debt crisis of the 1980s was followed by the introduction of wide-ranging economic reforms. And in the countries of Eastern Europe and the former Soviet Union the political transition precipitated a dramatic progress toward markets that succeeded as spectacularly in some countries as it failed in others.⁷

As a result of this move toward reforms the economic landscape in many developing countries—but not all—has been significantly altered. Government involvement in economic activity has been scaled back. Domestic markets are more open to international trade and capital flows. Revised tax codes are in place. And generally markets, not governments, determine prices, output, and the allocation of resources. Many—but not all—of these reforms reflected the principles of the so-called Washington consensus, which laid out 10 policy priorities that were adopted in different combinations by many countries (box 4.1).

Given the wide diversity of reforms implemented by different countries at different times and under different

Box 4.1
The Washington consensus

The Washington consensus of market-friendly reforms refers to the following 10 objectives of policy:

- Fiscal discipline.
- Redirection of public expenditure toward education, health, and infrastructure investment.
- Tax reform—broadening the tax base and cutting marginal tax rates.
- Interest rates that are market determined and positive (but moderate) in real terms.
- Competitive exchange rates.
- Trade liberalization—replacement of quantitative restrictions with low and uniform tariffs.
- Openness to foreign direct investment.
- Privatization of state enterprises.
- Deregulation—abolishment of regulations that impede entry or restrict competition, except for those justified on safety, environmental, and consumer protection grounds, and prudential oversight of financial institutions.
- Legal security for property rights.

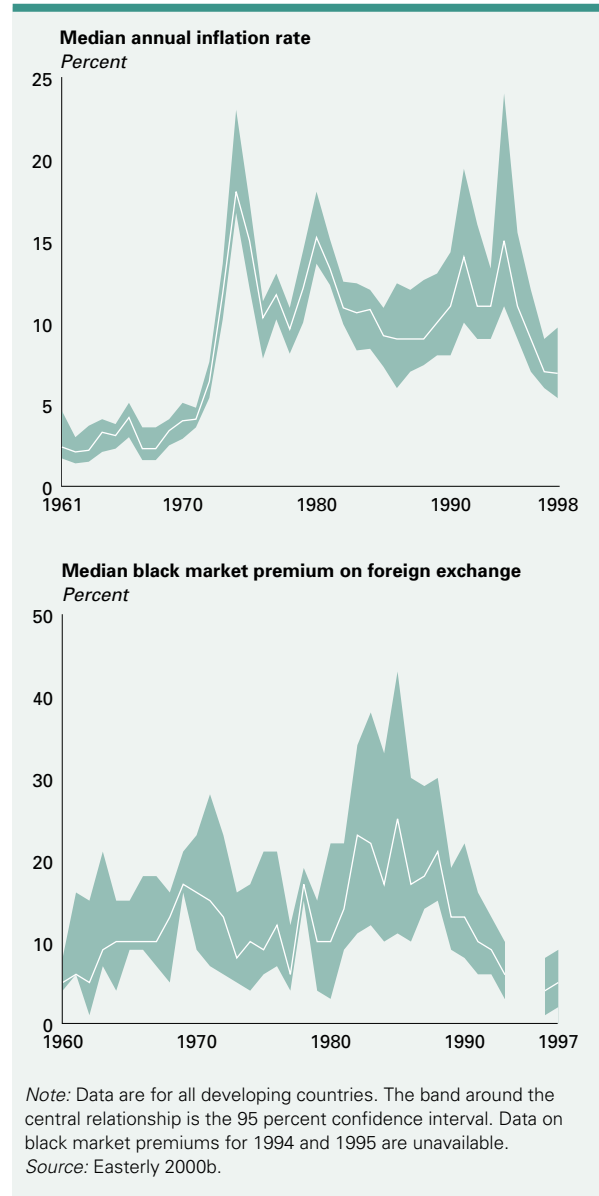
Source: Williamson 1993.

circumstances, summarizing overall progress is difficult. Nevertheless, encouraging indicators are clear (figure 4.1). For example, typical inflation rates in developing countries fell from around 15 percent in the early 1980s to 7 percent in 1997, indicating a broad trend toward more disciplined monetary policy. More important, many countries have escaped the scourge of chronic bouts of high inflation and hyperinflation. The black market premium on foreign exchange—a sure indicator of unrealistic and nonmarket exchange rates—fell from 25 percent for a typical developing country in the mid-1980s to only 5 percent in the late 1990s.

Reducing barriers to international trade and capital movements has been a central part of many reform programs. In Latin America average tariffs were reduced from 50 percent in 1985 to 10 percent in 1996, and maximum tariffs fell from an average of 84 percent to just 41 percent.⁸ By 1996 nontariff barriers affected only 6 percent of imports, down from 38 percent before reform.⁹ Reforms have also been widespread in other areas, such as liberalizing investment regulations, reducing or eliminating a large assortment of subsidies to bring down fiscal deficits, and privatizing many state enterprises. Only in labor markets have reforms generally been slow.¹⁰

Have these reforms delivered the expected growth payoff? A large empirical literature has documented that,

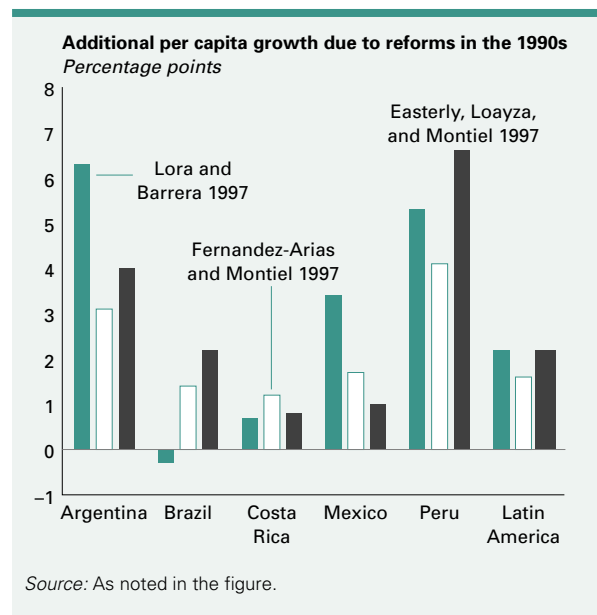
Figure 4.1
Indications of successful policy reforms in the developing world



on average, countries with market-friendly policies such as openness to international trade, disciplined monetary and fiscal policy, and well-developed financial markets enjoy better long-run growth performance than countries where such policies are absent (chapter 3).

There is also evidence that reforms that move countries closer to such market-friendly policies also contribute to better growth performance in the medium term. Cross-country studies of the impact of reforms typically either

Figure 4.2
Reforms delivered growth in Latin America,
although the gains varied



compare the performance of countries before and after reforms or else examine whether changes in measures of reforms explain changes in growth rates. Reforms are measured indirectly as changes in such variables as trade volumes, tariff rates, inflation rates, or budget deficits. Such studies often find a strong growth payoff from reforms. Figure 4.2 summarizes the results of three such studies for Latin America, which found a significant growth impact of reforms. Similar studies of the transition economies of Eastern Europe and the former Soviet Union, where success in implementing market reforms has varied widely, found that countries that implemented reforms forcefully and early (and enjoyed favorable initial conditions) achieved stronger growth than reform laggards.¹¹ A 1999 study of India finds that the states that implemented reforms saw faster growth and stronger improvements in education and primary health care than those that did not.¹²

This does not mean that the developing world as a whole enjoyed rapid growth as a result of reforms in the 1980s and 1990s. Indeed, growth in the developing world has been disappointing, with the typical country registering negligible growth.

A recent study argues that this disappointing growth should not be attributed to the failure of reforms.¹³ Despite slow overall growth, the study found that differences in indicators of market-friendly policies continued to

predict cross-country differences in economic performance. But many developing countries were buffeted by large external shocks. World interest rates rose sharply, increasing the burden of debt service obligations. Growth in the industrial countries slowed, lowering growth in their developing country trading partners. In some cases these shocks eroded the benefits of reforms that were being implemented concurrently.

At times, however, reform programs have failed to deliver as much as expected—and at times reforms have failed entirely. Consider what went wrong in East Asia, countries of the former Soviet Union, and Africa (box 4.2). The grim lessons of these failures, and the heavy burdens they placed on poor people, underline the importance of a measured and realistic approach to reforms to ensure that their objectives are attained.¹⁴

A note of caution on the future of reforms. In many cases the reforms discussed above are straightforward “first-generation” reforms, such as stabilizing from high inflation, moderating chronic budget deficits, and dismantling the most egregious trade barriers. Consolidating the gains from these reforms often requires institution building in much more difficult areas, such as developing an independent judiciary, creating independent and effective regulatory agencies, and instilling professionalism in the public sector. Such “second-generation” reforms are not only much more complex and take much more time—they are also often likely to be opposed by powerful and entrenched interests.¹⁵ This is not to say that such second-generation reforms should be postponed—precisely because they take time to bear fruit, it is important to embark on them as promptly as possible.

In sum, market-oriented reforms have been widespread though uneven throughout the developing world. On average they have delivered lower inflation and higher growth, both powerful forces for reducing income poverty. But reforms can also go awry, with painful consequences for poor people. Lack of supporting institutions, mistakes in sequencing reforms, and the capture of the reform process by powerful individuals or groups lie at the bottom of most failed reforms.

Have market reforms delivered benefits to poor people?

Even when market-friendly reforms have succeeded in delivering growth, the effects on the incomes of poor people have varied. This reflects both initial inequalities in

Box 4.2 Why do reforms sometimes fail?

Reforms can go awry when supportive institutions are absent or powerful individuals or groups manipulate the results.

Incomplete financial sector reforms contributed to the East Asian crisis

During the 1990s several emerging economies in East Asia liberalized their domestic financial markets and lifted capital account restrictions. In the Republic of Korea and Thailand especially, a surge of capital inflows, often through newly formed nonbank financial institutions, placed heavy financial stresses on banks. Prudential regulation of banks and nonbank financial institutions did not keep pace with these developments, and there was rapid growth in often-unhedged short-term foreign currency liabilities. Sudden exchange rate fluctuations in the summer of 1997 wreaked havoc on these foreign currency exposures, contributing to the depth of the ensuing crisis (World Bank 1998f).

This experience matches a broader pattern emerging from cross-country analysis: financial reforms unaccompanied by adequate supervisory institutions are a significant determinant of banking crises worldwide (Demirgüç-Kunt and Detragiache 1998). At the root of the 1995 Mexican peso crisis were inadequacies in the bank privatization process and in financial liberalization (Lustig 1998). These experiences do not invalidate the importance of reforms in developing financial markets. In fact, the effective intermediation of savings to productive investment was a contributing factor in East Asia's remarkable development success, a success that dwarfs the setbacks of the recent crisis. But incautious and excessively rapid reforms can culminate in crises.

Grand corruption subverted reforms in countries of the former Soviet Union

The state steals from us all the time, so deceiving the state is not a sin.

—From a discussion group, Ukraine

What kind of government do we have? One hand gives and the other takes away!

—From a discussion group, Ukraine

In the countries of the former Soviet Union market reforms and perceptions of corruption are inextricably intertwined (see, for example, Narayan, Patel, Schafft, Rademacher, and Koch-Schulte 2000). This is understandable: most of these countries score very poorly in cross-country comparisons of corruption, and encounters with corruption are dispiritingly frequent for many firms and individuals. Corruption has coincided with worse macroeconomic performance and deeper output declines as these countries have wrestled with the transition to a market economy.

A particularly pernicious form of corruption is “state capture,” referring to the ability of firms and powerful individuals to influence the formation of new laws and regulations to their own advantage. This may involve manipulating the judicial, executive, and legislative branches of government to obtain special privileges and mo-

nopoly rights and to bias the awarding and pricing of public contracts. State capture runs counter to the premises of a free and fair competitive market economy—and contributes to increasing inequality. State capture is also widespread. In several countries of the former Soviet Union more than 30 percent of firms surveyed in a business environment survey reported that they had suffered as a result of successful state capture by their competitors (Hellman and others 2000).

Market economies cannot function well where the institutional and incentive environment permits such corruption to flourish. Worse, countries may fall into vicious circles, with incomplete reforms creating new incentives for corruption. Fighting the corrosive effects of state capture requires much deeper institutional development—in the organization of the political system, the checks and balances among core state institutions, and the relationships between state and firms and between state and civil society.

Inadequate public investment and excessive bureaucracy have undermined market reforms in Sub-Saharan Africa

Several African countries have failed to grow since the mid-1980s, when, with the support of international financial institutions, they began implementing market reforms, especially in agriculture. The results have been less than spectacular, in part due to inadequate public investment and persistent red tape (World Bank 2000b).

African farmers, like those in other parts of the world, respond vigorously to price and nonprice incentives. But if public infrastructure—such as roads to remote agricultural areas—is undeveloped or underdeveloped, the impact of pricing and marketing reforms on output is muted. Inadequate infrastructure affects other sectors as well. Business surveys carried out in a number of African countries in 1996–97 consistently point to the poor quality of infrastructure services as a critical barrier to expansion into labor-intensive exports in response to trade reform. In Uganda transport and other costs increased the cost of capital goods by almost half. And in Zimbabwe poor transport services mean that delivery of inputs is unreliable, forcing firms to hold large inventories despite high interest rates.

These difficulties have been compounded by a lack of improvement in transparency and accountability. Although legal and regulatory changes are often integral parts of reform packages, their implementation is often flawed or half-hearted. As a result, regulatory barriers to competition remain serious obstacles, and corruption, red tape, and lack of transparency continue to impede trade and investment by raising costs. Business surveys often also identify corruption and bureaucratic red tape as barriers to business expansion and diversification in several African countries. For example, it can take more than a week for intermediate inputs to clear customs on the Ugandan border, and delays of more than a day are routine at customs checkpoints in southern Africa. These obstacles are symptomatic of larger institutional failures that policymakers must address if reforms are to be effective.

income and opportunity, and the effects of reforms on growth and inequality. What has actually happened? And what can be learned from this experience with market-friendly reform?

Cross-country evidence suggests that macroeconomic reforms on average have had little effect on income distribution. For example, recent studies have examined the impact of market-friendly policies—such as openness to international trade, low inflation, a moderate-size government, and strong rule of law—on the incomes of poor people in a large cross-country sample. The findings: these policies on average benefit poor people as much as anyone else.¹⁶ Some policies, notably stabilization from high inflation, may even benefit poor people more than others. This outcome is consistent with survey evidence showing that poor people are more likely to single out high inflation as a pressing concern.

Where reforms have adverse distributional effects, these are generally small compared with the growth benefits that reforms deliver, especially over periods of several years or more.¹⁷ So the macroeconomic evidence does not suggest that the benefits of reform have bypassed poor people—nor even that the benefits only gradually “trickle down” to them. Instead, it suggests a pattern in which all income groups on average benefit equally from reforms. Even among the countries of the former socialist bloc, where reforms have often gone awry, inequality increased least in countries that successfully implemented reforms. It increased most in countries that introduced reforms only partially or not at all.¹⁸

This kind of cross-country evidence provides only a partial picture of the effects of reforms on poor people. The same reforms may have very different effects in different countries, and so such average results provide only a rough guide to the likely future impact of reforms in a particular country. Furthermore, even when reforms on average have no effect on aggregate income inequality, there will still be winners and losers from reform. And when the main effects of reforms are on the provision of public goods such as health, education, or infrastructure, it may take time before the effects on income distribution and human development outcomes are felt. Detailed case studies of reforms in specific countries shed light on some of the complexities of reform. While it is as difficult to generalize from an individual country's experience as it is to generalize from an average cross-country relationship, both types of evidence provide useful insights into the effects of reforms.

Not surprising, case studies of reform episodes show that market-friendly reforms have uneven costs and benefits—especially in the near term—with the costs concentrated on particular groups and the benefits spread broadly over the economy as a whole. Costs and benefits can also be distributed unevenly over time. For example, trade liberalization can lead quickly to reductions in employment in previously protected sectors, but it may take time for affected workers to develop the skills required to take advantage of growing opportunities in other sectors. In Hungary the average duration of unemployment for those laid off from state enterprises between 1990 and 1992 was more than four years.¹⁹

Our leaders announced a transition to new market relations and then left us to the mercy of fate. . . .

—From a discussion group, Georgia

On the whole these costs do not negate the benefits of the reforms discussed above. But they do point to the importance of social policies to ease the burdens that reforms impose (see chapter 8). This is particularly so for poor people, whose assets, particularly the human capital of their children, can be irreversibly affected by even short-term costs. The costs also remind us that success or failure is not measured only by changes in average incomes. Survey evidence from Latin America indicates that reforms can be unpopular if they are associated with the perception—and often the reality—of greater risk and uncertainty.²⁰

Who wins? And who loses? The winners are often those in rural areas, those in countries where the enabling environment for the private sector is strong and private sector capacity to seize new opportunities is good, those with the skills to be absorbed into new activities, and those who are geographically mobile and willing to look for work in new occupations and sectors. The losers have often been in urban areas (where services have been hit), in government jobs, and in jobs where protected insiders once earned more than market wages would support. The losers might also include the unskilled, the immobile, and those without access to the new market opportunities—because they lack human capital, access to land or credit, or infrastructure connecting far-flung areas. The losers may also include otherwise viable firms hit by economic crises not of their own making.

As the state sector contracts, employment opportunities are evaporating.

—From a discussion group, Ukraine

Table 4.1
Impact of reforms on agricultural prices, output, and productivity in seven countries
Percentage change, five-year postreform period compared with five-year prereform period

Country	Real agricultural prices	Real exchange rate ^a	Real GDP growth rate (percentage point change)	Agricultural output	Agricultural productivity growth (percentage point change)
Chile	120	105	2.8	40	8.2
Ghana	5	230	3.9	50	12.2
Hungary	-10	-23	..	-15	25.4
Indonesia	20	75	-0.6	42	2.3
Madagascar	11	94	2.0	15	2.9
Mexico	-24	22	-3.7	14	1.3
New Zealand	-31	-2	0.4	5	0.8

.. Not available.
a. An increase indicates depreciation.
Source: Meerman 1997.

Since poor people are represented among both the winners and the losers described here, there can be no general lesson that reforms are good (or bad) for all poor people all the time. But examples of reforms in three areas—agriculture, fiscal policy, and trade—yield important insights into what determines success and failure, how reforms affect poor people, and whether it is possible to mitigate the adverse effects on losers.

Agriculture

Under inward-oriented models of development the structure of tariffs and nontariff barriers and often the exchange rate were biased against agriculture. Market-oriented reforms that reduced this antiagriculture bias—and dismantled various forms of state intervention (price supports, input and credit subsidies, support for marketing products)—have generally increased agricultural growth. Policy reforms such as privatization, reduced regulation, and trade and price liberalization have had a positive impact for many countries.²¹ Agricultural output and productivity growth have generally risen in the postreform period, sometimes substantially (table 4.1). Because many poor people are small agricultural producers, they have benefited directly from these reforms. Case studies of Chile, China, Ghana,²² Uganda, and Vietnam show that reforms have helped raise producer prices for small farmers by eliminating marketing boards, changing real exchange rates through broader economic reforms, lowering tariffs, and eliminating quotas (box 4.3).

As chapter 5 discusses, access to land plays an important part in poverty reduction. Better access to land, accompanied by access to such assets as credit and infrastructure, can improve the productivity of land and labor for poor people. Thus liberalizing land markets has large potential benefits. Evidence from Mexico, for example, indicates that land market reforms expanded small farmers' access to land through the rental market (box 4.4).

Beyond these direct benefits, growth in agricultural incomes appears to have been particularly effective at reducing rural poverty because of demand spillovers to local markets in which the nonfarm rural poor have a large stake. Rural construction, personal services, simple manufacturing, and repair have been major channels through which poor people have shared in agricultural booms, even when they have not been direct beneficiaries of higher crop prices. In Ghana the big beneficiaries of reform—cocoa producers—constitute less than 8 percent of the poor, yet rural poverty fell sharply.

All our problems derive from lack of land. If we have enough land we will be able to produce enough to feed our households, build houses, and train our children.

—Poor man, Nigeria

Another example of the indirect benefits of market reforms comes from cotton smallholders in Zimbabwe.²³ Before the reforms the Cotton Marketing Board used its power as the sole buyer to impose low producer prices on farmers to subsidize the textile industry. Large farmers di-

Box 4.3 Agricultural reforms in Chile and China help small farmers

Chile dramatically illustrates how incomplete reforms can harm agriculture—and how completed reforms can have large benefits. The military government that took power in 1973 implemented a sustained program of policy reform. Agricultural production increased by a quarter in 1974, but then stagnated through 1983, thanks to the uncertainty over future policies and the incompleteness of reforms. In 1978–82 elimination of credit and input subsidies and appreciation in the real exchange rate hit agriculture hard, while delays in implementing reforms in land, labor, and water rights markets prevented an effective response (Valdes 1994).

In 1984 an aggressive devaluation and completion of reforms led to a vigorous recovery. The sector responded strongly. Agricultural labor force participation quickly rose—from a low of 14 percent of the total labor force to more than 19 percent, substantially higher than at any time in the previous decade. Agricultural growth increased from 0.2 percent a year in 1960–74 to 4.9 percent in 1974–90. Greater land productivity was a major factor.

China's agricultural liberalization led to a swift response. Before the reforms in 1979, China had good roads and irrigation infrastructure, excellent technical packages for grains and other crops, and effective application of fertilizer and other inputs. Between the 1940s revolution and the 1970s, irrigation capacity had

more than doubled and fertilizer production had increased significantly. But arable land per capita declined from about 0.2 to 0.1 hectare over those 30 years. State-imposed cropping patterns forced most cultivation into rice and other cereals. Collective farms had to fulfill grain quotas for delivery to the cities, and the national grain market was fragmented into 30 self-sufficient regions.

Starting in 1979, family farming through the "household responsibility system" swept the country, replacing communal farming. Although initially farmers were still obliged to deliver grain at low prices, they were otherwise permitted to produce what they wished at mostly market prices. Commerce in rural areas and between farm and city, previously repressed by the state, was allowed to flourish. Rather than have self-sufficient provinces, the state encouraged regional and national markets. Effective demand increased rapidly for high-value products (vegetables, fruits, meat, fish, eggs) that had been repressed by the earlier state-directed policies. China's peasant farmers—skilled, hard working, and strongly motivated—responded to the new opportunities with great vigor and launched five years of the fastest sustained agricultural growth ever recorded anywhere. Between 1978 and 1984 net agricultural output increased 7.7 percent annually and grain output 4.8 percent (Lin 1995). With the vast majority of China's poor people in rural areas, the incidence of poverty fell dramatically.

Source: Meerman 1997.

Box 4.4 Land markets and poor peasants in Mexico

Liberalization of land rental and reorganization of the property rights system in the *ejidos* (communal lands) in 1992 formed the backbone of structural reforms to transform the Mexican economy. Liberalizing land markets and better defining and enforcing land property rights were expected to drastically reduce the costs of transactions in both land and credit markets, improving access to land and credit for poor, small-scale (and perhaps more efficient) producers.

Policies aimed at activating land rental markets would benefit the landless and the land-poor by increasing their access to land through rental and sharecropping transactions. But with both land and credit markets being liberalized, the easing of restrictions on

the land rental market could be offset by reduced access to credit for the land-poor, who were less able to use land as collateral. This could have shifted the benefits from smaller to larger holders.

The increased supply of land from large farmers in the rental market allowed the rural poor a small but statistically significant increase in access to land. After controlling for the greater access to credit, it appears that large farmers increased their demand for land rentals. But small farmers appear to have increased their demand for land even more, suggesting that had their access to credit not worsened, land-poor farmers might have benefited even more from land market liberalization.

Source: Olinto, Davis, and Deininger 1999.

versified into unregulated crops, such as horticulture and tobacco. After the reforms cotton prices rose. In absolute terms the gains would be greater for larger farmers, simply because they produce more cotton. But there have been particular gains for smallholders, as newly privatized cotton buyers have chosen to compete with one another in part by providing new extension and input services to smallholders.

We think the earth is generous; but what is the incentive to produce more than the family needs if there are no access roads to get produce to the market?

—From a discussion group, Guatemala

Market-friendly reforms have also sometimes hurt the rural poor. In some countries financial reforms tight-

Box 4.5 Listening to farmers in Zambia

Since 1991 Zambia has radically changed the policy and institutional environment for agriculture. With liberalization and privatization, private suppliers have replaced state agricultural services for credit, inputs, and marketing.

Using participatory rural appraisals and beneficiary assessments, the World Bank–assisted Agricultural Sector Investment Program has established systematic and regular feedback between policymakers, service providers, and those affected by programs. Talking to farmers has helped policymakers understand the farmers' resource constraints, service delivery problems, and strategies for dealing with the vicissitudes of transition.

Participatory assessments also examine local perceptions of the effectiveness of agricultural infrastructure and services. These consultations revealed that agricultural credit and marketing, now handled by the private sector, were uneven and unpredictable—because of poor infrastructure, lack of capacity, and inadequate enforcement mechanisms. Public extension and animal health services, suf-

fering from staff shortages and lack of operating funds, transport, and equipment, were also failing to respond well to farmers' needs.

Farmers want better infrastructure (especially roads and bridges) and more effective regulation of the private sector. They also want more information on markets for agricultural products and easier access to more flexible and responsive credit facilities. And they want advice on subsistence crops and storage methods, which they prefer to get through group extension.

Talking to farmers also identified ways to help those who are economically vulnerable take part in agricultural markets—extending microcredit, promoting local seed production systems, and offering research and extension services for subsistence crops and low-input agriculture. To create the local organizational basis for participatory extension and economically viable joint activities—such as marketing, local financial services, and cattle dipping—support needs to go to producer associations, service-providing NGOs, and other organizations active in communities.

Source: World Bank 1998a.

ened credit and closed rural bank branches, reducing the availability of credit.²⁴ And in some cases research, data collection, reporting, and quality monitoring disappeared after the abolition of state enterprises and marketing boards. In Cameroon the marketing board had been maintaining rural roads, but the responsibility was not reassigned after the reforms. In Zambia remote farmers had been implicitly subsidized by a uniform pricing policy that did not take into account transport costs, while small farmers without storage facilities were implicitly subsidized by prices held constant across seasons. After the reforms market forces eliminated the implicit subsidies, and transport infrastructure deteriorated significantly, leaving many farmers worse off.

The converse of the gain to small producers from relative price shifts is the cost to poor urban dwellers. Take Ghana. The rural sector gained from higher export prices and greater rural demand as cocoa farmers spent their windfall, but urban residents grew poorer. Living standards in Accra deteriorated in 1988–92, even while conditions were improving elsewhere in the country. Poor and middle-income urban residents suffered from higher food prices. Moreover, the dismantling of the old export marketing system removed an important source of public revenues that was not quickly replaced. This led to higher inflation and public sector retrenchment, with the costs of both felt most by urban residents.

These examples suggest at least two lessons. The first is simple: reforms can benefit poor people but also hurt them. Listening to stakeholders through participatory policymaking can do much to identify and avoid unintended consequences for poor people (box 4.5). Second, when reforms leave an institutional vacuum, performance suffers. As with other reforms, agricultural market liberalization without the proper institutional framework will not deliver the expected results—and could have serious consequences for poor people.

Fiscal policy

In many countries fiscal reforms to strengthen revenue collection capacity and control unsustainable spending have been a central element of broader reform programs. Since raising revenues takes time, fiscal reforms often show up first in spending cuts. When those cuts are felt in social sectors and in subsidies, they can hurt poor people. As chapter 5 discusses, there is evidence that the introduction of user fees in health services hurts the poor more than the rich. In Madagascar the real incomes of poor households in the capital city declined substantially when food prices were decontrolled.²⁵ But eliminating subsidies does not always hurt the poor. A study in Guinea and Mozambique found that eliminating food subsidies did not hurt poor people because the subsidies had not reached them in the first place.²⁶ The lesson is clear: lower overall subsidies need not be inconsistent with

helping poor people, if the subsidies are better targeted or replaced by other forms of assistance.

In the 1990s governments in Eastern Europe and the former Soviet Union introduced a rapid phaseout of utility subsidies across the board. The urgency was dictated by the need to reduce unsustainable fiscal deficits. This had a huge impact on the welfare of all families, especially poor families. In Ukraine household energy tariffs increased four- to twelvefold (in real terms) between 1992 and 1995, while average household income dropped to less than half its prereform level. To help cushion the impact, a cap of 20 percent of family income was put on what households pay in utility bills and rent. The state budget is supposed to pay any bills in excess of this limit (although arrears in payments continue to be a problem). In Moldova the average winter heating bill would have exceeded 60 percent of the income (cash and in kind) of a typical family of four in the lowest fifth of the income distribution living in a small apartment. Aware that this was unsustainable, the government eventually introduced mechanisms to subsidize families, ranging from tolerating nonpayment to establishing different tariff rates for poor families.²⁷

Experience in the countries of the former Soviet Union also shows that fiscal adjustment could have been done in different, and much more pro-poor, ways. For example, before the political transition the ratio of health and education personnel and facilities to the total population was above OECD standards. During the 1990s public revenues and expenditures fell as a share of GDP. And since GDP collapsed as well, government spending in real terms fell dramatically. Rather than downsize personnel, rationalize facilities, and institute some cost-recovery measures, governments allowed real public sector wages to erode, and spending on maintenance and material inputs collapsed. Public sector wages were often in arrears, and public employees responded to their personal financial pressures by demanding under-the-table payments for public services, something poor people could ill afford.²⁸

Revenue-raising measures, such as a growing reliance on value added taxes, can also hurt poor people if not implemented carefully. Strong efficiency arguments for value added taxation are being heeded throughout the developing world. But introducing such taxes can have either progressive or regressive effects. If value added taxes replace progressive income taxes or if poor people either avoided or did not qualify for other taxes, such reforms are regressive. Pakistan's introduction of a value added tax

shifted the burden of taxation toward the poor: the tax burden on the richest income group declined 4.3 percentage points, while that on the poorest group rose 10.3 percentage points.²⁹ In contrast, when tax reforms reduce the reliance on inflationary finance, they can be progressive because of the heavy burden high inflation places on poor people. Moreover, most of the redistributive power of public finance lies on the expenditure side rather than the revenue side. Therefore, even a slightly regressive tax reform can have progressive results if the additional revenue is devoted to expenditures targeted toward poor people.

Trade

Trade reforms—reducing tariffs and nontariff barriers—have had profound effects in many developing countries. As chapter 3 discusses, there is now substantial evidence that open trade regimes support growth and development and that moving toward an open regime and its attendant benefits is the reason for trade reform. But the consequences for poor people depend crucially on how trade liberalization affects the demand for their greatest asset: their (often unskilled) labor. Furthermore, trade reforms in the developing world have not always been matched by complementary reforms by rich countries, where the remaining protection imposes a heavy burden on the developing world (chapter 10).

The initial push for trade liberalization as an instrument for poverty reduction was influenced by a narrow reading of predictions from trade theory: removing trade barriers in developing countries would increase demand for their abundant low-skilled labor and expand unskilled employment and earnings. Not only would trade liberalization raise average incomes—it was also expected to be particularly pro-poor through this effect on unskilled labor. The evidence shows that the actual results in the past 15 years have been mixed. Trade reforms have delivered growth, and thus poverty reduction—but their distributional effects have been more complex. Careful analysis suggests three main factors at work.

First, in some countries trade restrictions had benefited poor people by artificially raising the prices of the goods they produced. In such cases it is not surprising that trade liberalization would hurt poor people. For example, a study of Mexico found that the wages of unskilled labor relative to those of skilled labor declined over 1986–90, and that about a quarter of the decline was from the reduction in tariffs and the elimination of import license requirements (figure 4.3).³⁰ The authors explain this ap-

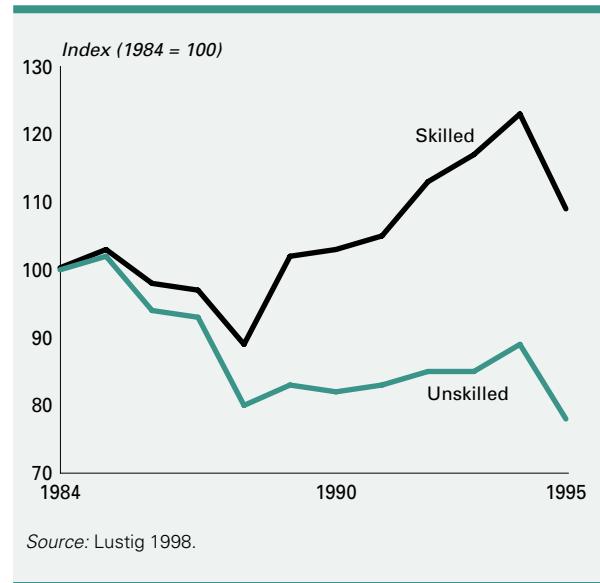
parent anomaly by noting that Mexico, despite its comparative advantage in low-skilled industry, had protected labor-intensive sectors—such as textiles and clothing—before adopting trade reforms. Supporting the incomes of the unskilled through trade barriers is very inefficient. Support can often be given in other ways at lower social cost, although designing and implementing such better-targeted programs take time. But it is not surprising in these circumstances that trade liberalization—unaccompanied by compensatory programs—would hurt poor people. In some other countries, however, the pattern was different: urban manufacturing workers protected by trade barriers were more skilled and less likely to be poor.

Second, some countries that liberalized trade were not particularly abundant in unskilled labor. In Africa and Latin America land is relatively abundant, and in Eastern Europe skilled labor is plentiful. Although this does not detract from the efficiency and growth arguments for trade reform, it does call into question the earlier presumption that trade reform might also deliver equalizing effects by raising the demand for unskilled labor. But in countries where unskilled labor is abundant, such as Bangladesh, China, and Vietnam, the gains from integrating into the world economy can be significant for unskilled labor.

Third, trade reforms were often accompanied by other developments that were disequalizing rather than equalizing. In many developing countries that opened to trade, as in many industrial countries, the wages of skilled workers have grown faster than those of unskilled workers. In the United States the wages of unskilled workers have fallen in real terms by 20 percent since the 1970s, despite rapid growth in the overall economy.³¹ Studies for countries as diverse as Chile, Colombia, Mexico, Turkey, and Venezuela show a similar phenomenon—premiums paid to skilled workers have increased in all these countries.³²

Is trade the culprit behind this widening inequality? The balance of evidence suggests that it is not. More important has been technological change favoring workers with better education and skills, sometimes in the form of imported foreign technologies. This can be seen from several pieces of evidence. Even though the relative wages of skilled workers have risen in many countries, there has also been a shift toward greater employment of skilled workers—contrary to what simple trade theory would predict. This shift has been pervasive across industries—again contrary to simple trade models, which would have predicted increases in some sectors and declines in others. And there is evidence that the pattern of shifts toward more

Figure 4.3
The gap between skilled and unskilled wages widened in Mexico



skill-intensive employment in the industrial world in the 1970s and 1980s is being matched by a similar, later shift in the developing world.³³

This is of course not to say that technological change should be avoided because it hurts poor people. On the contrary, technological change is a fundamental determinant of growth and rising living standards, powerful forces for poverty reduction. Instead, the importance of a rising relative demand for skills points to the need to invest in the skills of poor people, to enable them to take advantage of the new opportunities that technological change brings.

Private sector response

These examples of agricultural, fiscal, and trade reforms show that reforms can have complex distributional outcomes. But remember that the objective of market-friendly reforms—a vibrant and dynamic private sector—can be one of the most effective antidotes to the costs of reform. New job creation, technological change that raises labor productivity and wages, and institutions that ensure equal opportunities for gaining access to the new jobs do much to ensure that the benefits from reform are widely shared.

Fortunately, a strong private response appears to be the general experience in developing countries after reform, especially when labor market regulations are not onerous and do not inhibit adjustment.³⁴ A retrospective study of

trade liberalizations found that in 12 of 13 cases where data were available formal manufacturing employment increased within one year after liberalization was completed.³⁵ The exception was Chile, where increased employment in agriculture offset the decline in manufacturing employment. In Estonia a flexible labor market created many new jobs, leading to minimal unemployment despite the intense job destruction and labor turnover associated with reform.³⁶ In Panama unemployment fell steeply after liberalization. In South Asia growth in the formal manufacturing sector accelerated from 3.8 percent a year to 9.4 percent after liberalization, as many workers pulled out of informal sector employment.³⁷ And in Africa the micro and small enterprise sector is the most dynamic in five economies considered in a recent study. Annual employment growth was strong in these enterprises after reform, and new enterprises started up at a high rate.³⁸

Making markets do more for poor people

Even where market-friendly reforms have taken hold, there is much that countries can do to improve the benefits that markets offer to the poor. To reach poor people, many reforms need to be accompanied by institutional support, investment in infrastructure, and complementary reforms at the micro level. The incentives for policymakers to undertake such reforms are small because the markets involving poor people are typically small. So the reforms get little attention, even though they can be powerful forces for poverty reduction. But increasing access to productive assets and lightening and improving regulation can do much to involve poor people more directly in markets.³⁹ New technologies can help as well, especially information technologies that break down some of the barriers of physical remoteness that many poor people face (box 4.6).

The potential of reforms to improve access to markets for poor people can be seen from examples in three areas: lifting the heavy hand of regulation, especially on the small businesses that often provide the poor with employment; promoting core labor standards; and improving access to financial markets for the poor, especially through microfinance.

Lightening the regulatory burden

Compliance with regulations imposes fixed costs that are particularly onerous for small firms. Carefully re-

viewing regulations and exploring possibilities for more flexible requirements can ease the burden. In Chile the government recently simplified the duty-drawback system to reduce the administrative costs for small firms. In Bolivia parts of the tax system were drastically simplified for small firms.⁴⁰ In the Philippines there are much lower minimum capital requirements for small thrift and rural banks than for commercial banks.

In contrast, in Indonesia official and unofficial levies are estimated to raise the costs faced by small and medium-size enterprises by as much as 30 percent.⁴¹ In some sectors small enterprises have to secure as many as eight licenses—some of which have identical functions but are issued by different agencies. Obtaining licenses takes so long and procedures are so complicated that some business owners choose to operate illegally.⁴² In the Indian state of Gujarat licensing requirements for gum collectors are a barrier that hinder women's collector groups.⁴³ Reforms to reduce levies and to simplify and shorten licensing and entry procedures for small and medium-size enterprises could ease this burden.

Given the opportunity, small and medium-size enterprises might serve some segments of the markets normally thought of as natural monopolies. In many urban areas in Africa and Latin America small independent water providers bring basic water services at low cost to poor marginal communities. Small enterprises have also been effective in solid waste management.⁴⁴ But they often face barriers—such as requirements for experience, complex or expensive procedures for registration and tendering, and noncompetitive behavior in markets. Removing these constraints could allow small and medium-size enterprises to expand their activities in this area, increasing employment opportunities for low-income groups while expanding access to services for poor communities.

Better regulation does not always mean less regulation. Take the privatization of gas, water, electricity, and telecommunications utilities in Argentina in the early 1990s. Privatization improved performance, and poor people, as direct consumers, benefited along with the rest of the economy—and more than proportionately for gas and electricity, major components of their consumption basket. But because privatized utilities are often monopolies, appropriate regulatory institutions were essential to fair pricing. The new regulations to ensure that utility prices yielded only normal rates of return had important indirect benefits for poor people, by encouraging investment

Box 4.6 Attacking poverty with information

Virtual Souk expands market access for artisans in the Middle East and North Africa

Fadma Aoubaida, a Moroccan weaver from Taliouine and a mother of seven—with the money she earned from selling her products on the Virtual Souk—repaired her roof and started building an indoor latrine, one of the few in her village. Ijja Aittalblhsen, another woman artisan in Morocco, spent her profits to buy cement and windows for her house. With future profits, she wants to buy a truck to transport rugs from her village to the market or buy bicycles that women can ride.

—BBC Online News, 14 October 1999

Artisans in the Middle East and North Africa have always crafted high-quality products using traditional techniques and ancestral know-how. But shrinking local markets and difficulties in gaining access to more lucrative national and international markets are leading to a gradual disappearance of culturally rich crafts—and with them an important source of income for poor people.

The Virtual Souk is bucking this trend. Since 1997 this Internet-based marketplace has been providing direct access to international markets for several hundred artisans from Egypt, Lebanon, Morocco, and Tunisia, many of them women. The network is expanding to other countries in the region, and there is demand to adapt the concept to East Asia and Latin America.

Online sales soared tenfold between the first and last quarters of 1999, reaching markets around the world, including countries in Europe and North America and as far as Australia, Japan, and South Africa. Participating artisans receive 65–80 percent of the proceeds, a much larger margin than through traditional channels. And the gains are more than simply financial. Through the Virtual Souk, artisans

Source: For the Virtual Souk, see www.peoplink/vsouk/; for the Grameen Telecom cellular phone program, see Burr (2000).

gain access to opportunities for empowerment, capacity building, income generation—and for the use of their skills with dignity.

Cellular phone technology gives bargaining power to women in Bangladesh

I always sell eggs to middlemen. In the past, whatever prices they offered, I accepted because I had no idea about the going prices of eggs. . . . Last week, the middleman came . . . and desired to pay me 12 taka per hali [four units]. . . . Keeping him waiting, I rushed to check the prices through the Village Phone. The price was 14 taka per hali of eggs in nearby markets. I came back and refused to sell to him at the lower prices. . . . After a brief haggling, we agreed to buy and sell at 13 taka per hali.

—Halima Khatuun, a poor, illiterate woman who sells eggs, Bangladesh

A subsidiary of Grameen Bank, Grameen Telecom operates a village pay phone program that leases cellular telephones to selected bank members, mostly women in rural areas, who use the telephone to provide services and earn money. Today around 2,000 village pay phones are in place. The target is to install 40,000 telephones by 2002, introducing telefax and email services as well.

These phones have helped lower the cost of information gathering. This can be seen in lower prices for poultry feed, more stable diesel prices, and less spoilage of perishable goods due to more precise shipment dates. Women providing the phone services have gained confidence and new status as “phone ladies.” Telephone users include both rich and poor, but poor people make more calls for economic reasons.

and job creation throughout the economy. One study found that these indirect gains for poor people—reflecting the power of appropriate regulation—were five times as large as the direct gains from lower utility prices and better service.⁴⁵

An appropriate and generally lighter regulatory framework in labor markets could also benefit poor people. In general, excessively burdensome labor market regulations can limit job creation and thus opportunities for poor people to productively employ one of their most important assets—their labor. These constraints are especially important when reforms in other areas create temporary employment dislocations. But the benefits of deregulating labor markets should not be overstated. Often labor market regulations are not well enforced, especially in the informal sector, so relaxing them would have little effect on employment opportunities for poor people.

Promoting core labor standards

Core labor standards have been set out in the Declaration on the Fundamental Principles and Rights at Work adopted by the members of the International Labour Organization in 1998. They include freedom of association and the right to collective bargaining, elimination of forced labor, effective abolition of child labor, and the elimination of discrimination in employment and occupation.⁴⁶

The goals underlying these core labor standards are important, and it is widely agreed that the standards themselves represent worthy targets for economic development. This consensus is especially strong for the most exploitative forms of child labor and forced labor. However, there is no consensus regarding the best way to achieve the labor conditions envisaged by these core standards. How best to implement the objectives set out in these standards is difficult to determine and depends a great deal

on the circumstances of individual countries. Some industrial countries take the position that the standards should be enforced through trade agreements or development cooperation. Many developing countries argue—and rightly so—that applying trade sanctions in this way can serve protectionist purposes for industrial countries and that conditioning development cooperation will unfairly hamper development.

It is clear that simply adopting core labor standards will not guarantee their realization. In developing countries problems meeting these standards may be a consequence of poverty.

Consider child labor. Too often children's time spent at work comes at the expense of their formal schooling—with likely adverse long-term consequences. But a child's earnings may make the difference between survival and starvation for the family, or they may help provide the resources for a sibling to stay in school.⁴⁷ In these circumstances simple bans on child labor can have adverse consequences for poor families' incomes and can even have the unintended effect of pushing children from work in the formal sector to more exploitative work in firms outside the reach of formal regulations. As a complement to standards against the most exploitative forms of child labor, programs that provide financial incentives that make it affordable to keep children in school can be a very effective strategy.⁴⁸

Implementation of the standards on freedom of association and collective bargaining also raises complex issues for economic development. Enshrining such rights can help eliminate abusive workplace practices and ensure fair compensation, especially for poor people, whose desperate need for employment places them most at risk of unfair and exploitative employers. Unions also are an important dimension of civil society, and consultation with unions can provide a valuable input into policy formulation. However, empirical evidence on the economic benefits of unionization and collective bargaining is generally quite mixed and suggests that both costs and benefits are complex and context specific.⁴⁹ Particularly important are the rules that govern collective bargaining and resolution of labor disputes. Some forms of collective bargaining rules may be better at producing efficient and equitable outcomes than others.⁵⁰ In any case, the exercise of these rights will best serve development objectives when unions and employers are knowledgeable and independent and bargain in good faith.

The core labor standards, then, set an important target, but a simple strategy of enforcing them through sanc-

tions is unlikely to produce the desired outcomes for workers.⁵¹ Rather, promoting them as part of a broad-based development strategy through information, technical assistance, capacity building, and complementary initiatives is likely to yield the greatest benefits. Using incentives—such as programs to keep children in school—to address the causes of suboptimal labor practices must be a key part of this strategy. Along these lines, and also deserving close attention, are interesting new ideas about complementing public standards with private (market-driven) standards that encourage employers to adopt desirable labor practices.⁵²

Improving access to financial markets for poor people

Access to financial markets is important for poor people. Like all economic agents, low-income households and microenterprises can benefit from credit, savings, and insurance services. Such services help to manage risk and to smooth consumption in the face of sharp fluctuations in agricultural yields and prices, economic shocks, and even natural disasters. Savings and credit facilities can help to make larger investments more affordable, and so allow people to take advantage of profitable business opportunities and increase their earnings potential. For economies as a whole, a large literature has documented the importance of well-functioning financial markets for growth.⁵³

But financial markets, because of their special features, often serve poor people badly. Asymmetric information between lenders and borrowers creates problems of adverse selection and moral hazard. The traditional solution to these problems is for lenders to demand collateral from borrowers. Since poor people have insufficient traditional forms of collateral (such as physical assets) to offer, they are often excluded from traditional financial markets. In addition, transactions costs are often high relative to the small loans typically demanded by poor people. And in areas where population density is low, physical access to banking services can be very difficult: in the mountains of Nepal people must walk six hours to and from the nearest bank branch at an opportunity cost of a day's wages.⁵⁴ Facing such hurdles, poor people are often discouraged and simply do not seek loans since they believe that they will be denied credit or will not be able to fulfill bank requirements. At the same time, conventional banks often find it unprofitable to provide services to poor people using traditional lending practices.

These failures have been used to justify a high level of government intervention in the form of targeted credit, with government-owned financial institutions channeling sizable resources at subsidized interest rates. Often, this approach assumed that poor people required only cheap credit, ignoring their demand for savings instruments.⁵⁵ Outcomes were disappointing. The lending institutions were not financially viable, and in countries from Indonesia to Peru government-sponsored rural credit programs collapsed under the weight of their losses. Subsidized interest rates distorted the financial markets. Target groups were not reached.⁵⁶

So many lending institutions have emerged, but their operations are hardly transparent. People do not know how to access them. Those who have tried have been let down by high levels of collateral demanded.

—From a discussion group, Malawi

Over the past two decades new approaches known collectively as microfinance have emerged, applying sound economic principles in the provision of financial services to low-income clients and using group as well as individual lending. Pioneers such as Grameen Bank in Bangladesh and the village banks (*unit desas*) of Bank Rakyat Indonesia captured attention worldwide by providing financial products matching the needs of low-income clients, using innovative collective monitoring through group lending to strengthen repayment performance, and charging interest rates that fully cover operational costs.⁵⁷ In many cases these innovations led to much higher repayment rates than under previous schemes—and were particularly effective in reaching women.⁵⁸

While such programs have become popular and represent a major step forward from previous public interventions, they are still no panacea for poverty. Not surprising, simply providing access to credit does not create investment opportunities: a study of rural households in Nicaragua and Romania found that removing credit constraints would have only moderate impacts on the number of households making investments and on the amounts invested.⁵⁹ In addition, small, locally based microfinance organizations can be particularly vulnerable to shocks such as natural disasters or fluctuations in agricultural yields, which affect a large proportion of their clientele at once. This can raise the riskiness of their loan portfolios and make it more difficult for them to provide more sophisticated financial products. Shar-

ing these risks among microfinance organizations and possibly encouraging a greater role for larger and more geographically diversified and established financial institutions can help in this respect.

Careful measurement of the economic impact of microfinance programs or institutions is fraught with methodological difficulties, and the results of studies are often contradictory.⁶⁰ Nevertheless, evidence is gradually emerging. For example, a recent review of 13 microfinance institutions found that borrower households above or on the poverty line experience a higher impact than households below the poverty line, suggesting that while effective, such institutions are not necessarily well targeted toward the poorest households.⁶¹ Another study found that the majority of microfinance programs reviewed still required financial subsidies to be viable.⁶² Increasingly, the performance of these institutions is evaluated by two primary criteria: their outreach to target clientele and their dependence on subsidies.⁶³ Although these criteria do not provide a full assessment of the economic impact of microfinance institutions, they highlight the social cost at which microfinance institutions have reached their objectives.

These results on targeting and the prevalence of subsidy dependence point to the challenges faced by microfinance programs: continuing to move toward financial viability while extending their outreach to their target clientele. Best-practice design features of such institutions as the village banks of Bank Rakyat Indonesia—interest rates that fully cover costs, availability of well-rewarded voluntary savings, performance-based compensation for staff, intensive staff training, innovative low-cost distribution networks, frequent loan collection, products matching the demand of low-income groups, and effective management information systems—are all associated with good financial performance. Stronger capacity building and better dissemination of these best practices can help microfinance institutions wean themselves from subsidies without compromising their ability to provide services to poor people.

Governments can improve financial intermediation for the poor by providing complementary public goods and improved regulation that recognize the special needs of microfinance schemes. For example, better investment in rural infrastructure and literacy promotion can help expand the reach of microfinance organizations, and credit information registries can lower informational costs and allow borrowers to build reputational collateral.

On the regulatory and supervisory fronts outdated usury laws that prevent microfinance institutions from establishing sufficiently high spreads between savings and lending rates to allow them to cover the high transactions costs on small loans should be eliminated. Improving the legal framework for secured transactions, as is being done in Argentina, Mexico, and Romania, can widen credit opportunities for low-income people.

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Well-functioning markets create opportunities for poor people to escape poverty. But establishing such markets where they are absent, making them work better, and ensuring that poor people have free and fair access are difficult and take time. At times, market reforms fail entirely—or have unintended consequences for poor people. The lessons of these failures point to the importance of designing and implementing reforms in a way that is measured and tailored to the economic, social, and political circumstances of a country. Market-friendly re-

forms create winners and losers. And when the losers include poor people, societies have an obligation to help them manage the transition.

However, there is no presumption that making reforms pro-poor means making reforms slowly. In some cases poor people will benefit more from rapid market-oriented reforms, especially in areas that directly affect their economic opportunities or that help break down entrenched monopoly privileges. In view of the urgent need to get countries onto dynamic, job-creating development paths, it is critical that the difficulty of reform and the impossibility of compensating every loser not lead to policy paralysis.

Furthermore, to make markets work better for poor people, macro reforms must be complemented by micro reforms and improvements in poor people's access to markets and information—through investment in infrastructure and modern technologies—as well as sources of credit. Reducing labor market restrictions that limit job creation and stifle competition while promoting core labor standards remains a key challenge.